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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1944

No. 1024

In the Matter of

WAERN BUILDING CORPORATION,
Debtor.

ERNEST MORRILL,
Petitioner,

vs.

WAERN BUILDING CORPORATION,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your Petitioner, Ernest Morrill, objecting bondholder, respectfully prays that a writ of *certiorari* issue to the Circuit Court of Appeals for the Seventh Circuit to review a judgment of that court entered on November 8, 1944, (petition for rehearing denied December 18, 1944) affirming an order of the United States District Court for the

Northern District of Illinois, Eastern Division, confirming a plan of reorganization. A certified transcript of the record in the case, including the proceedings in the Circuit Court of Appeals is furnished herewith in accordance with the rules of this Honorable Court.

Statement of the Matter Involved.

The court below held as fair and equitable a plan of reorganization under Chapter X of the Bankruptcy Act, which extended the first mortgage bonded indebtedness of $141,800.00 for six years and reduced the interest rate from 7% to 4½% (amounting to about $20,000.00 for the six-year extension) and at the same time permitted stockholder participation, in direct contravention of the full priority rule repeatedly announced by this court. In *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, for example, Mr. Justice Douglas, speaking for a unanimous court, said at Page 529:

> "If they (creditors) receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation. This is not permissible." (Insert ours)*

Such a plan is not and cannot be "full compensatory treatment" and clearly amounts to an appropriation of property rights for the benefit of stockholders, without compensation.

In its opinion, the Circuit Court of Appeals avoided the obligation of the priority rule by holding that this petitioner did not object to the plan on this ground, either

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* To the same effect:

Northern Pacific Railway Co. v. *Boyd*, 228 U. S. 482, 508; *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106; *Group of Investors* v. *Milwaukee Railroad*, 318 U. S. 523, 556.

before the referee or the District Court, and, hence, could not raise the point for the first time on appeal. The Court of Appeals said (R. 233):

> "Appellant next argues that the plan violates the absolute priority rights of the bondholders because it does not provide for 7% interest. It is true that the bonds provide for an accelerated interest rate after maturity of 7% and that under the plan stockholders participate to the extent of their equity while the bondholders' interest rate is 4½%. The record shows that the appellant never objected to the plan on this ground at any time, either before the referee or the court. * * * Since he did not, the objection may not be raised for the first time in this court."

The Court below, in so holding, disregarded the plain provisions of Sec. 174 and Sec. 221 of Chapter X of the Bankruptcy Act, and failed to observe, moreover, the uniform decisions of this court holding that it is the affirmative duty of the District Court to examine the evidence to determine if the plan is fair and equitable as a matter of law. The trust indenture is in evidence and clearly shows a violation of the priority rights of the bondholders.

Almost every mortgage note or bond issued in the State of Illinois provides for interest at the rate of 7% after maturity of the debt, and the Courts of Illinois have uniformly held that such a rate of interest after maturity is just as much a contract provision for interest as the rate provided to be paid before maturity. *Schmisseur* v. *Rebhan,* 294 Ill. App. 172, 179; 13 N. E. (2nd) 627, 629 (1938); *Carson* v. *Rebhan,* 294 Ill. App. 180, 183 (1938); 13 N. E. (2d) 630, 631; Reeve, Illinois Law of Mortgages and Foreclosures (1932), Vol. 1, P. 185; also Vol. 2, P. 740. The 7% interest rate is expressly authorized by the Statute of the State of Illinois. See Chap. 74, Sec. 4 (Interest), Ill. Revised Statutes (1943) State Bar Association Edition. Under the Interest Act of Illinois (Chap. 74, Sec. 4) a

corporation may agree to pay interest without limit and beyond the rate specified for natural persons. *Simon* v. *South End Cleaners Inc.,* 246 Ill. App. 14 (1927).

The ruling of the court below approving a plan extinguishing the right to receive interest at the contract rate is in necessary conflict with the decisions of the Courts of Illinois, which have consistently recognized and enforced the right to receive the contractual increased interest rate after default. *Chicago City Bank & Trust Co.* v. *Bremer,* 189 Ill. App. 258; Reeves, Illinois Law of Mortgages and Foreclosures, Vol. 1, P. 190. Hence, the decision is in necessary conflict with an Illinois rule of property and presents a question of major importance in reorganization law which has not been, but should be, settled by this court. Several plans of reorganization have been confirmed in the Northern District of Illinois (before the decision of the Court of Appeals was handed down in the instant case), which recognized and enforced the right of bondholders to 7% interest after maturity in accordance with the express provision of the note and mortgage.

Waern Building Corporation, the Debtor, owns a four-story, furnished apartment building situated on the southwest side of Chicago, Illinois. The building and its furnishings constitute virtually its sole assets. In November 10, 1927, the Chicago City Bank and Trust Company underwrote a first mortgage bond issue for $165,000.00, the proceeds of which were used, or intended to be used, to construct the building in question. The bonds were sold by the bank to the general public (R. 84, 158). The trust indenture, securing the bond issue, designated the bank as trustee. Construction of the building was completed in May of 1928.

From 1927 to 1936, $8,000.00 of the bonds were retired. In 1936, the bond issue, then $157,000.00, was in default and the Debtor filed a voluntary petition for reorganiza-

tion under Section 77B (R. 158). On May 12, 1936, a plan of reorganization was confirmed which extended the bond issue to May 10, 1942. New bonds in the sum of $157,-000.00 were exchanged for old. A new trust indenture was executed designating the same bank as indenture trustee. The new bonds, interest coupons, and trust indenture, all dated May 10, 1936, and all approved by the District Court, provided for interest at the rate of 4% from May 10, 1936, to May 10, 1939; 5% from May 10, 1939, to May 10, 1942, *and 7% after maturity.* The Debtor was required to deposit monthly up to May 10, 1939, the sum of $291.67, and thereafter annually, the sum of $3500.00, in a sinking fund to be used for the retirement of bonds at par or the lowest tendered price. If the Debtor's earnings were insufficient for the sinking fund deposits, it agreed to obtain the necessary funds from other sources (R. 66).

On May 10, 1942, the bond issue, then $141,800.00, was again in default. On May 12, 1942, Chicago City Bank and Trust Company, as indenture trustee, filed a foreclosure in the Circuit Court of Cook County, Illinois, to foreclose the trust deed. On the same day, the Debtor filed this, its second application for reorganization. Both the foreclosure and the reorganization petition alleged the inability of the Debtor to pay the balance of the bond issue, viz., $141,800.00. In its petition asking for a second reorganization, the Debtor scheduled its liabilities and capital structure as follows:

First Mortgage Bond Issue, principal due (Plus interest of 7% per annum after May 10, 1942)	$141,800.00
100 Shares Class A Preferred Stock, $100.00 par value	10,000.00
71 Shares Class B Preferred Stock, $100.00 par value	7,100.00
6680 Shares of Common Stock, no par value.	

After various hearings at which the proposed plan was modified by eliminating the common stockholders and the Class B stockholders, leaving outstanding only the bonds and new no par common stock, the new common stock to be distributed pro-rata to the holders of Class A Preferred Stock, the District Court confirmed the plan.

Summary of the Plan.

Briefly, the plan of reorganization contemplates the formation of a new corporation, the elimination of Series B and the common stock, the issuance of new common stock pro-rata to the Class A Preferred stockholders, the transfer of legal title to the building and furnishings to the new corporation, and the assumption by the new company of the bond issue and the trust indenture. The plan provides for a second extension of the bond issue, i. e., from May 10, 1942, to May 10, 1948, with interest at 4½% annually *and 7% after maturity.* The 4½% interest rate was fixed by the Debtor by taking the average interest rate which the Debtor paid to the bondholders from 1936 to 1942, the extension period under the 77B plan. The Debtor again commits itself to deposit annually, out of earnings or from other sources, the sum of $3500 in a sinking fund for the retirement of bonds at par or the lowest tendered price and to deposit all net rentals with the indenture trustee. Except for a straight payment of 4½% interest to bondholders and the advancement of the maturity date of the debt to May 10, 1948, the plan, as it concerns bondholders, is precisely the same plan as confirmed in 1936.

The Effect of the Plan.

a. For the second time in a federal reorganization proceeding, and within six years, it extends the time for the payment of the bond issue.

b. It reduces the rate of interest to bondholders from 7%, the rate fixed in the bonds and trust indenture as payable after maturity (May 10, 1942), to 4½%, and at the same time permits stockholder participation.

c. It maintains the Class A Preferred Stock in the position of full equity ownership and in full control of the new corporation unless default occurs, notwithstanding its interest in the equity is relatively small, if, indeed, there is an equity.

d. It again requires the Debtor to make an annual deposit of at least $3500.00 from its earnings or other sources in a sinking fund for the retirement of bonds. The Debtor has no "other sources" and its past earning record over 14 years demonstrates its incapacity to meet this requirement. Under the plan, in the event of default, foreclosure is the sole remedy.

Objections of Petitioner to the Plan.

For purposes of later discussion, it is necessary to point out here that petitioner, a bondholder, objected before the Referee and the District Court to the approval and confirmation of the plan on grounds that the plan was not fair and equitable, or feasible; that a similar plan confirmed under 77B failed; that there was no reasonable likelihood this plan could succeed and hence the seed of a third reorganization was being sown; that on the basis of its past record the Debtor would be unable to meet its annual sinking fund requirements of $3500.00; that from 1928 to 1936 only $8000.00 in bonds were retired; that from 1936 to 1942 only $15,200.00 in bonds were retired; that the property has depreciated and will depreciate more than the amount of bonds retired annually; that there is no reasonable likelihood that the Debtor will be able to retire or refund the bond issue in 1948; that a

favorable market presently exists for the property involved and it should be sold at an upset price to be fixed by the court pursuant to Section 216 of Chapter X of the Bankruptcy Act; that bondholders who desire payment of their bonds should now be paid; that in the event of a default under the plan bondholders should be permitted to sell or acquire the property without the expense and delay incidental to foreclosure; that the Debtor whose equity, if any, is relatively nominal, would continue to have complete control over the building; that no competent valuation data was available to the court or creditors at the time of the hearing on the plan for submission to the interested parties; that the court should have appointed an independent appraiser to appraise the property; that the indenture trustee has sponsored the plan because it has a personal interest in the compensation it receives for acting as trustee and in the deposits it secures for the bank; that the activities of the indenture trustee in the purchase and sale of the bonds in question and in the formation and dissolution of a bondholders protective committee and other transactions require full investigation by the court; that the indenture trustee occupies conflicting positions and should be removed; that in view of the public interest and the conduct of the indenture trustee, the Securities and Exchange Commission should be invited to participate in the proceeding.

Jurisdiction to Review.

The judgment of the Circuit Court of Appeals for the Seventh Circuit was entered November 8, 1944. Petition for rehearing was denied December 18, 1944. The jurisdiction of this court is invoked under Sec. 240 (a) of the Judicial Code, as amended by Act of February 13, 1925 (28 U.S.C.A. Sec. 347 (a)) and Sec. 24 (c) of the Bankruptcy Act, as amended in 1938 (11 U.S.C.A. 47).

Statute Involved.

The statute involved is Chapter X (Secs. 174 to 221) of the Bankruptcy Act, as amended (11 U.S.C.A. 47). Sec. 174 reads in part as follows:

> "* * * The judge shall enter an order approving the plan or plans * * * which are fair and equitable and feasible * * *."

The pertinent portion of Sec. 221 is:

> "The judge shall confirm a plan if satisfied that the plan is fair and equitable, and feasible * * *."

Under Section 216 (10) of Chap. X it is provided that a plan may provide for

> "the sale of all or any part of its property, either subject to or free from any lien, at not less than a fair upset price and the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein; * * *."

Questions Presented.

1. Where under an extension plan confirmed under 77B in 1936, it is provided in the bonds and trust indenture (approved by the District Court) that the bond issue shall be extended to May 10, 1942, and that bondholders shall be paid interest at the rate of 4½% from 1936 to 1939; 5% from 1939 to 1942, *and 7% after maturity* (May 10, 1942) and where the plan failed because the debtor could not pay the bond issue at its maturity, does a new plan filed in a new proceeding which again extends the bonds to May 10, 1948, reduces the rate of interest from 7% to 4½%, and at the same time permits stockholder participation, violate the *absolute priority rule* as announced by this Court in the *Los Angeles Lumber Case* and other cases?

2. Was the Circuit Court of Appeals correct in holding as a matter of law that notwithstanding a plan of reorganization violates the priority rights of creditors, neither the Circuit Court of Appeals nor the District Court is required to take cognizance of the violation unless specific objection is raised in the District Court?

3. Where a debtor corporation's sole asset is a furnished apartment building and its principal debt is the balance due on a first mortgage bond issue, does a plan of reorganization meet this court's test of feasibility when it proposes, for the second time in six years, to extend the bond issue in the face of its past earnings record extending over fourteen years, which indisputably discloses that it has never at any time been able to meet its sinking fund requirements of $3,500.00 annually for bond retirement, and where the record fails to show any reasonable probability that it will be able to pay or refund the balance of the indebtedness at the end of the second extended period?

4. Is the rule requiring full disclosure by a trustee as announced by this court in *American United Mutual Life Insurance Co.* v. *City of Avon Park*, 311 U. S. 138, violated by an indenture trustee, the underwriter of the bond issue, which fails to disclose (1) its personal interest in the plan; (2) how and when it acquired the bonds it owns; (3) how much was paid for the bonds it owns and from whom the bonds were purchased; (4) to what extent it has trafficked in the bonds; and (5) its activities in the formation and dissolution of a bondholders protective committee? The District Court and the Court of Appeals ignored this question.

5. Chapter X, Sec. 216 (10) of the Bankruptcy Act expressly authorizes a plan of reorganization providing for the sale of the debtor's property at an upset price. Does *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608, prohibit the approval or confirmation of such a plan?

Reasons Relied On for Allowance of Writ.

1. The Court of Appeals ruled that notwithstanding the rate of 7% interest after maturity is fixed in the bonds and the trust indenture, a plan of reorganization may extend the maturity date of the debt, fix an interest rate lower than the contract rate, and at the same time permit stockholder participation. Almost every mortgage note and trust indenture in the State of Illinois provides for interest at 7% after the maturity of the debt. Courts of Illinois have uniformly upheld interest at 7% after maturity in suits on notes and foreclosures on mortgages. Are the rights of bondholders less because their bonds are extended in a reorganization proceeding? Plans of reorganization have been confirmed in the Northern District of Illinois (before the decision of the Court of Appeals was handed down in the instant case) which recognized the right of noteholders to 7% interest after maturity in accordance with the express provisions of the note and mortgage. The rule of law announced by the court below is in direct conflict with the Illinois law and presents a question of major importance in reorganization law which has not been, but should be, settled by this Court.

2. The Court of Appeals departed from the statutory mandate in Chapter X (Secs. 174 and 221) of the Bankruptcy Act and from the decisions of this Court in the *Los Angeles Lumber Case*, 308 U. S. 106; *First National Bank* v. *Flershem*, 290 U. S. 504, and *National Surety Co.* v. *Coriell*, 289 U. S. 426, in holding that a *specific* objection to a plan as violating the priority rule *must* be filed by a creditor in the District Court before it can be raised on appeal. Even a general objection to the plan as not "fair and equitable, or feasible" was not considered sufficient by the Court of Appeals. Under Secs. 174 and 221 of Chapter X and the applicable decisions of this Court, it is

the affirmative duty of the District Court, even if no objections are filed, to examine the proof to determine if the plan is fair and equitable, and feasible.

3. In holding that the contract interest rate of 7% after maturity, fixed by the bonds and trust indenture, may be reduced and at the same time stockholders allowed to participate in the plan, the opinion of the Court of Appeals departs from the principle announced by this Court in *Group of Investors* v. *Milwaukee Railroad, etc.*, 318 U. S. 523, and *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, viz., that accrued interest at the contract rate shall be treated the same as principal and shall be given the same priority as principal before stockholders may participate in the reorganization.

4. In declaring the plan feasible, the Court of Appeals disregarded the poor past earnings record of the building in question and relied almost entirely on current or war earnings, contrary to the rule stated by this Court in *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, and *Group of Investors* v. *Milwaukee Railroad, etc.*, 318 U. S. 523. The opinion disregards the only practical test of feasibility in a real estate reorganization, viz., on the basis of the past earnings record of the building, will the net income be sufficient in amount and stability to provide the regular payments of interest together with the periodic payments on the principal so that at maturity the remaining mortgage debt can be paid or readily refunded? In a real estate enterprise the chief asset has a limited economic life and funds are not set aside for replacement as in an industrial enterprise. This Court has never applied the test of feasibility to a plan involving a real estate enterprise.

5. The Court of Appeals failed to distinguish between a hearing on the question of whether or not a plan should be *approved for submission to creditors and stockholders,*

pursuant to Sec. 174 of Chapter X of the Bankruptcy Act, and a hearing on *confirmation* under Sec. 221. Before a plan may be approved for submission, there should be available to the court and the interested parties competent valuation data from disinterested sources relating to the debtor's property and its earning capacity so that the court and the interested parties may intelligently determine whether the plan is fair and equitable, and feasible. This information was not available at the time of the *hearing on this plan for submission to the interested parties.* The production of this information at the hearing on confirmation (after the plan had been submitted to the interested parties and the vote taken) does not cure the defect. The Court of Appeals made no comment on this objection. Failure to observe this procedural requirement of Chapter X may operate, as it did here, to the detriment of the bondholders. Without such valuation data the court was not in a position to exercise its "informed, independent judgment" and creditors could not intelligently vote on the plan.

6. The Court of Appeals and the District Court failed to follow the holding of this Court in *American United Mutual Life Insurance Company* v. *City of Avon Park,* 311 U. S. 138 in requiring the indenture trustee, the underwriter of the bond issue, to make a complete disclosure of its activities.

7. Chapter X, Section 216 (10) of the Bankruptcy Act expressly authorizes a plan providing for a sale of the debtor's property at an upset price. Pursuant to Section 167 (6) of Chap. X and in view of the favorable market we suggested to the Referee the sale of the building at an upset price. The Referee rejected the suggestion on the ground that "Chapter X contemplates reorganization rather than liquidation" (R. 104). Since *Fidelity Assurance Association* v. *Sims,* 318 U. S. 608, some doubt has

existed as to whether a plan may provide for the sale of the debtor's property at an upset price. Real estate enterprises have constituted and still constitute the bulk of reorganization proceedings in the Federal Courts. It is frequently desirable to sell the property under a plan. A decision by this Court on the question whether or not a plan may provide for a sale of all the debtor's assets at an upset price and removing the doubt created by the *Sims* case, is of prime importance in reorganization law.

PRAYER.

Wherefore, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Court, directed to the United States Circuit Court of Appeals for the Seventh Judicial Circuit, commanding said court to certify and send to this Court on a day to be designated, a full and complete transcript of the record and of all proceedings of the said Circuit Court of Appeals had in this cause, to the end that this cause may be reviewed and determined by this Court; that the judgment of the Circuit Court of Appeals for the Seventh Judicial Circuit affirming the order of the District Court be reversed and remanded, and the petitioner be granted such other and further relief as may seem proper.

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Counsel for Petitioner

Simon H. Alster,
Kernal Freeman,
Of Counsel.

(26)

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OPINION BELOW.

The District Court did not render a written opinion but merely entered an order confirming the plan of reorganization as amended (R. 210-212). The Referee filed reports on the petitioner's objections to the plan (R. 93-109, 157-174).

The opinion of the Circuit Court of Appeals (R. 232-239) has been officially reported at 145 Fed. (2) 584.

STATEMENT OF THE CASE.

A statement of the matter involved has been fully presented in our petition and the Court is respectfully referred to pages 2 to 6 therein. In the interest of brevity, the statement is not repeated here.

SPECIFICATION OF ERRORS.

The Circuit Court of Appeals erred:

1. In holding as fair and equitable a plan of reorganization which reduces the interest rate to bondholders and at the same time allows stockholders participation.

2. In holding that a *specific* objection to a plan of reorganization that it violates "priority rule" must be raised by a creditor in the District Court before it can be urged on appeal.

3. In holding the plan of reorganization feasible which further extends a bond issue where, from the past earnings record of the real estate involved, the net income will be insufficient not only to meet the current requirements of the plan but to retire or refund the debt at the end of the extension period.

4. In failing to distinguish between a *hearing on a plan for submission to the interested parties*, pursuant to Sec. 174 of Chapter X of the Bankruptcy Act and a *hearing on confirmation* of the plan under Sec. 221.

5. In holding the evidence did not warant investigation and removal of the indenture trustee.

6. In holding that it was not error for the District Court to refuse to authorize a plan for the sale of the debtor's property *because that would be tantamount to liquidation.*

SUMMARY OF ARGUMENT.

1. A plan of reorganization which permits stockholders to participate and at the same time reduces the contract rate of interest to bondholders violates the "absolute priority rule" as announced by this Court in the *Boyd Case* and *Los Angeles Lumber Case* and is not fair and equitable as a matter of law.

2. The opinion of the Court of Appeals holds that since petitioner, an objecting bondholder, never specifically objected in the District Court to the violation of the absolute priority rights of bondholders he is precluded from raising the question on appeal. The record shows that petitioner objected to the submission of the plan and to its confirmation on the ground that it was *not fair and equitable, or feasible*. Under Chapter X of the Bankruptcy Act and the applicable decisions of this Court, it is the affirmative duty of the District Court, even though no objections are filed, to reject a plan which from the face of the record violates the priority rights of bondholders.

3. The court below disregarded the test of feasibility laid down by this Court to the effect that the debtor's normal earning capacity is the most important criterion in determining the feasibility of a plan of reorganization. In the case at bar, the Debtor's sole asset consists of a furnished apartment building, some fourteen years old. The plan under consideration provides for a second extension of the bonded debt for six years, with periodic payments of interest, taxes and deposits in a sinking fund for retiring the bonds, totaling an amount which the Debtor, even when the building and furnishings were newer, has never been able to earn. Temporary present earnings due to the current housing shortage caused by

the war, constitute no criterion for determining whether or not the plan is feasible.

4. At a hearing on the question of whether or not a plan should be approved for submission to creditors and stockholders pursuant to Section 174 of Chapter X of the Bankruptcy Act, there should be available to the Court and interested parties competent valuation data from disinterested sources relating to the Debtor's property and earning capacity to the end that the Court may exercise its own "informed, independent judgment" concerning the fairness and feasibility of the plan and the interested parties may intelligently vote on the plan. The submission of such data *after consents have been procured* does not satisfy the statute.

5. The Court of Appeals and the District Court failed to follow the holding of this Court in *American United Mutual Life Insurance Company* v. *City of Avon Park,* 311 U. S. 138, in requiring the indenture trustee, the underwriter of the bond issue, to make a complete disclosure of its activities.

6. Chapter X, Section 216 (10) of the Bankruptcy Act authorizes the approval of a plan providing for a sale of the Debtor's property at an upset price. *Fidelity Assurance Association* v. *Sims,* 318 U. S. 608, does not prohibit the approval or confirmation of such a plan.

ARGUMENT.

I.

A plan of reorganization which permits stockholders to participate and at the same time reduces the contract rate of interest to bondholders violates the "absolute priority rule" as announced by this Court in the Boyd Case and Los Angeles Lumber Case and is not fair and equitable as a matter of law.

It is now a firmly established principle in federal reorganization law that "any arrangement of the parties by which subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of * * * creditors comes within judicial denunciation." *Louisville Trust Company* v. *Louisville, New Albany & Chicago Railway,* 174 U. S. 674; *Northern Pacific Railway Co.* v. *Boyd,* 228 U. S. 482; *Case* v. *Los Angeles Lumber Products Co.,* 308 U. S. 106. It is equally settled that any plan of reorganization which violates the full priority rights of creditors is not fair and equitable as a matter of law and may not be approved by the Court. *Case* v. *Los Angeles Lumber Products Co.,* 308 U. S. 106; *Consolidated Rock Products Co.* v. *DuBois,* 312 U. S. 510.

Applying these rules here, we submit the plan is not fair and equitable. Under the bonds and the trust indenture (R. 56) bondholders were entitled to receive interest at the rate of *5% per annum from May 10, 1939, to May 10, 1942, and interest at the rate of 7% per annum after May 10, 1942,* the maturity date of the bonds. Under

the plan the interest rate to bondholders is reduced from 7% to 4½% from May 10, 1942, to May 10, 1948, and at the same time stockholders are permitted to participate.

It is significant that two of the three judges of the Court of Appeals who heard this case apparently did not concur with Judge Kerner, who wrote the opinion, in his holding that the priority rule was not violated. Judge Kerner said (R. 234):

> "My colleagues concur in the conclusion that appellant is precluded from raising this question for the first time on review. The author of this opinion, however, feels impelled to add this paragraph *which represents his own personal opinion.*" (Italics ours.)

Judge Kerner then proceeds to state that the priority rule is not violated because any stockholder participation is more nominal than real, being restricted, so far as any beneficial enjoyment goes, to the distant future; that stockholders do not receive any dividends; that although the corporation has legal title to the property, all the earnings must be used for the benefit of the bondholders, and that *Group of Industrial Investors* v. *Chicago, Milwaukee, St. Paul & Pacific Railroad Co.,* 318 U. S. 523, 546, does not hold "that a provision in the original bonds as to an accelerated rate of interest after maturity must be the interest rate which is to be included in the plan if stockholders participate." (R. 234-235)

It is true, as Judge Kerner says, that bondholders receive the entire net earnings of the building until their bonds are fully paid, and the shareholders' right to receive any part of the earnings is correspondingly postponed. However, the interest rate is cut down and to the extent it is reduced the interest of the equity owner increased. What is taken from the bondholders is given to preferred stockholders. Stockholders benefit in direct proportion to the extent the interest rate to bondholders

is cut down. If there is, in fact, an equity for the stockholders then there is no basis for depriving the bondholders of their full contract right, viz., 7% on their bonds for the full period of extension. If there is none, then, of course, they should not participate at all either presently or because of any optimistic belief in the future. Since any curtailment in the contract rate of interest to creditors increases correspondingly the equity of the stockholders, in this sense stockholders definitely participate in the plan and benefit, though their enjoyment of financial benefit is postponed. If bondholders here receive only 4½% interest instead of 7%, as provided in the contract, stockholders get the benefit of interest at the rate of 2½% per annum, about $3500.00 a year, or about $20,000.00 over a period of six years.

On the subject of interest, this Court said in *Group of Investors, et al.* v. *Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 318 U. S. 523, 546:

> "Finally, it is argued on behalf of some of the stockholders that the effective date of the plan under Section 77B must be the date of the filing of the petition, the theory being that Section 77B does not permit the accrual of interest after that date. In *Consolidated Rock Products Co.* v. *DuBois, supra,* we held, under Section 77B that *interest on secured claims accrued to the effective date of the plan was entitled to the same priority as principal.* The definition of the terms 'creditors' and 'claims' was substantially the same under Section 77B, Sub. (b) as it is under Section 77 * * * We see no reason why the same result should not obtain here." (Italics ours.)

Commenting on the question of interest, the court said in *Consolidated Rock Products* v. *Du Bois*, 312 U. S. 510, 527:

> "In the first place, no provision is made for the accrued interest on the bonds. This interest is entitled to the same priority as the principal."

We do not understand the holding of this Court to mean (as the Court of Appeals ruled) that the Court distinguishes between interest which accrues *before maturity* and interest which accrues *after* the *maturity* date of the debt. We understand the *priority rule* to mean that creditors are entitled to full compensatory treatment in accordance with their contract before stockholders may participate.

The instant plan was not approved and confirmed until November 8, 1943 (R. 210). By that time about seventeen months' interest at 7% had accrued (from May 10, 1942), which, under the holding in the *Milwaukee* case (318 U. S. 523, 546), was entitled to the same priority as the principal. Even this was eliminated by the plan (R. 13). In its treatment of the interest upon the principal indebtedness the Court of Appeals, therefore, went directly contrary to the decision of this court as to interest on secured claims.

Escape is sought, in the opinion below, from the full effect of the priority rule by resort to the theory that the provision for interest at 7% applies to the period after maturity and that "the very soul and purpose of the present plan is to extend the maturity date" (R. 234). This, it is respectfully urged, is both unrealistic and unsound. There is no magic in the word "maturity." The contract, including the obligation to pay interest, is as much alive after final payment is due, as it was before. Extensions of maturity provided by plans of reorganization under Chapter X must contemplate extension of the then existing obligation which includes principal and interest at the contract rate when default occurs. The default occurring, the agreed condition to the increased interest rate came into being. The debt under the first extension already had matured when the debtor came to court with its voluntary petition. That maturity was an accomplished fact and that same

maturity was not extended under the present, second reorganization. Rather, a *new* maturity date for the payment of the obligation of a *new* corporate entity was created under the plan.

Rights of first mortgage creditors must be considered as they are when listed as debts in the proceeding. The proof of their claims contemplates proof of the existing indebtedness. After that demonstration the court considers what may fairly and equitably and feasibly be done with the existing situation of the debtor, which must include the total of its contract obligations as to both principal and interest. The first mortgage bondholders here possessed the right by contract to receive 7% interest after May 10, 1942. The plan destroys that right, and, furthermore, permits stockholders to participate in the new corporation.

The 7% interest rate payable after maturity, as provided by the 77B plan of 1936, is authorized by the Statute of the State of Illinois. Chapter 7, Sec. 4 (Interest) Illinois Revised Statutes (1943) State Bar Association Edition. Virtually all mortgages or trust indentures in the State of Illinois provide for interest at the rate of 7% after maturity. Courts of Illinois have uniformly upheld the provision of interest at 7% after maturity in suits on notes and foreclosures on mortgages. *Schmisseur* v. *Rebhan*, 13 N. E. (2d) 627, 294 Ill. App. 172, 179 (1938); *Arneson* v. *Haldane*, 105 Ill. App. 589; *Carson* v. *Rebhan*, 13 N. E. (2d) 630, 294 Ill. App. 180, 183 (1938); Reeve, Illinois Law of Mortgages (1932), Vol. 1, p. 185; also Vol. 2, p. 740. Federal District Judge Campbell of this district has approved several plans allowing 7% after maturity as fixed by bonds and mortgages. (Windsor Wilson Liquidation Trust, Jeffery Terrace Building Corporation, Karcher Hotel Co.)

In *Coder* v. *Arts*, 152 Fed. 943, 950 (C.C.A. 8th) the Court said:

> ". . . the mortgagee is entitled to payment of the interest upon his mortgage debt as well as the principal, out of the proceeds *in accordance with the terms of the note and mortgage*." (Italics ours.)

Assuming instead of an extension of the bonded indebtedness the property had been sold and the sale had produced a sum sufficient to pay bondholders the full principal of their bonds plus accrued interest, would bondholders have been entitled to 7% interest after May 10, 1942, the maturity date, or an "average" fixed by the debtor? It would seem that they would be entitled to 7% after maturing before any distribution of the funds could be made to stockholders. Are the rights of bondholders any less because their bonds are extended in a reorganization proceeding? If the indenture trustee had proceeded with its foreclosure, there can be no question but that bondholders would be entitled, as a matter of right, to a decree of 7% after May 10, 1942, in accordance with their notes and with the trust indenture.

The 4½% rate provided in the plan is the average rate which the bondholders received from 1936 to 1942. If the debtor is permitted to pay an "average" rate of interest it has paid over a past period, it would appear to be legally permissible for the debtor to pay less than an average. What, then, becomes of the "priority rule"? If an average for the past six years may be taken, why not an average from the time the bond issue was created in 1928 when the interest rate was 6%? A reasonable rate of interest does not satisfy the contract rights of bondholders. A rate of interest in accordance with the temporary, current money market is not the test of fairness. (The Referee found that the interest rate was a "favorable" one in these times (R. 105).) It cannot even be said that bondholders who have been receiving 5% interest from 1939 to 1942 are in as good a position by a plan which now offers them 4½%. The opinion of the Court

of Appeals holds that stockholders have no real participation because they get no income until the bonds are paid. This is no answer to a reduction or confiscation of their contract right to receive full compensatory treatment. What is taken from bondholders goes to stockholders.

The Court of Appeals completely neglected to observe the important and immediate, though non-financial, participation accorded to shareholders under the plan. As far as the property is concerned, stockholders control it; they control the legal title; they control the management of the building during the extension period. Only in case of default will control pass to bondholders.

The effect of the plan compels the conclusion that bondholders are not accorded their full priority rights which the decisions of this Court require be given them before stockholders are allowed participation. Hence, the plan is not fair and equitable as a matter of law.

II.

The opinion of the Court of Appeals holds that since petitioner, an objecting bondholder, never specifically objected in the District Court to the violation of the absolute priority rights of bondholders, he is precluded from raising the question on appeal. The record shows that petitioner objected to the submission of the plan and to its confirmation on the ground that it was not fair and equitable, or feasible. Under Chapter X of the Bankruptcy Act and the applicable decisions of this Court, it is the affirmative duty of the District Court, even though no objections are filed, to reject a plan which from the face of the record violates the priority rights of bondholders.

It is, of course, settled that an objection may not ordinarily be raised for the first time in a reviewing court.

However, a federal reorganization proceeding is not like ordinary litigation which is determined on the basis of evidence which the parties choose to submit. In this case the debtor sought relief, modification and extension of its obligations to creditors and the Congress has provided certain statutory admonitions to prevent the technically captious treatment of creditors' rights. Even if no objections have been raised to a plan of reorganization, it is the duty of the District Court to examine the record and determine if a plan is fair and equitable as a matter of law. The court is the guardian of those creditors who have not assented to the plan—in this case, about 18% of the bond issue or about $25,000.00 in bonds (R. 141-144).

Sec. 174 of the Bankruptcy Act (11 U.S.C.A. 47) specifically provides:

> "* * * The judge shall enter an order approving the plan or plans * * * which are fair and equitable, and feasible * * *"

Sec. 212 of Chapter X of the Bankruptcy Act provides:

> "The judge shall confirm a plan if satisfied that the plan is fair and equitable, and feasible * * *"

The Bankruptcy Act thus places on the Court, irrespective of objections filed, the positive duty to examine into the fairness and feasibility of a plan. As this Court said in *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 114:

> "A contrary conclusion in such case would make the judicial determination on the issue of fairness a mere formality and would effectively destroy *the function and duty imposed by Congress on District Courts under Section* 77B." (Italics ours.)

This Court said in *First National Bank* v. *Flershem*, 290 U. S. 504, 525:

> "In justifying the action taken, *the Court of Appeals called attention to the fact that the non-assent-*

ing creditors had not introduced any evidence to prove their contentions that the sale should not be confirmed. * * * The failure to secure an adequate price seems to have been due, not to lack of opposing evidence, but to the mistaken belief that it was the duty of the court to aid in effectuating the Plan of Reorganization since a large majority of the debenture holders had assented to it. *Moreover, the Court stood in a position different from that which it occupies in ordinary litigation where issues are determined solely upon such evidence as the contending parties choose to introduce.* In receivership proceedings, as was held in *National Surety Co. v. Coriell*, 289 U. S. 426, 436, every important determination by the court calls for an 'informed, independent judgment'." (Italics ours.)

Finletter, The Law of Bankruptcy Reorganization (1939), says at page 474:

> "The Act places on the Court the positive duty of examining the proof as to fairness and feasibility. The minority is not to be put to the expense of assembling the evidence to the contrary. Any such burden would be too severe. The Court in effect is the guardian of those who do not assent to the proposal * * *"

Here, the trust indenture was in evidence as part of the record (R. 59-82). A mere reading of it discloses that bondholders are entitled to 7% interest after maturity or May 10, 1942. It was patent from an examination of this document that the rights of bondholders were violated by the plan. It is settled that one is not required to specifically object to what is apparent from an inspection of the record. We objected to the submission of the plan and its confirmation on the ground that it was not fair and equitable, and feasible (R. 104, 153). While the Court of Appeals deemed this general objection insufficient, it is submitted that the District Court is not thereby relieved of its duty to examine the trust inden-

ture and to determine if the priority rights of creditors have been violated. An entire class of creditors may not be penalized merely because the Court's attention was not directed to a violation of the contract rights of creditors. Chapter X of the Bankruptcy Act furnishes the District Court ample facilities—by the appointment of a Special Master or (as in this case) a Referee, or an examiner, or a trustee—to determine and advise the Court if the superior rights of creditors are preserved.

The opinion of the Court of Appeals fails to recognize this established rule in federal reorganization law—the function and duty imposed on District Courts to examine the plan and the proof to determine if the plan is fair and equitable as a matter of law. The opinion views reorganization proceedings as ordinary litigation compelling creditors to exercise vigilance and diligence in asserting their rights lest they lose or waive those rights. Petitioner, the opinion holds, should have specifically objected in the court below. Failing to do so, he (and it follows all the bondholders) have lost their rights. This is not the intent or the spirit of the Act or the decisions of this Court.

III.

The court below disregarded the test of feasibility laid down by this Court to the effect that the debtor's normal earning capacity is the most important criterion in determining the feasibility of a plan of reorganization.

In the case at bar, the Debtor's sole asset consists of a furnished apartment building, some fourteen years old. The plan under consideration provides for a second extension of the bonded debt for six years, with periodic payments of interest, taxes and deposits in a sinking fund for

retiring the bonds, totaling an amount which the Debtor, even when the building and furnishings were newer, has never been able to earn. Temporary present earnings due to the current housing shortage caused by the war, constitute no criterion for determining whether or not the plan is feasible.

The feasibility of a plan of reorganization is fundamentally essential to its confirmation. While courts are not required to possess infallible prescience, they must, in estimating the future, take heed of past earning experience. There should be some reasonable assurance from the history of the enterprise and from rationally anticipatable earnings that the plan will be carried out so that further resort to judicial aid will be unnecessary.

On this subject, this court said in *Consolidated Rock Products* v. *DuBois*, 312 U. S. 510, 525:

> "Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a *sine quo non* to the determination of the integrity and practicability of the new capital structure."

The court said further, at page 526:

> "The necessity for such an inquiry is emphasized by *the poor earnings record of this enterprise in the past.* Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. * * * it is also essential for satisfaction of the absolute priority rule of *Case* v. *Los Angeles Lumber Products Co., supra.* Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result." (Italics ours.)

That the income resulting from operations augmented by war conditions is no test for the appraisal of the future,

was held by this court in the *Milwaukee Railroad* case, 318 U. S. 523, where the court said at page 543:

> "We cannot assume that the figures of war earnings could serve as a reliable criterion for that 'indefinite future.' "

Quoting from a statement of the Interstate Commerce Commission, the court said, at page 543:

> " 'We know from past experience that the upswing in business which war brings is temporary and likely to be followed by an aftermath in which conditions may be worse than before.' "

Then, using language certainly applicable to the plan under consideration, the court said (page 543):

> "As some of the bondholders point out, the bulge of war earnings *per se* is unreliable for use as a norm unless history is to be ignored; and numerous other considerations, present here as in former periods, make them suspect as a standard for any reasonably likely future normal year."

The limited economic life of real estate enterprises requires even more scrupulous compliance with standards of sound finance than ordinary industries. Corporate reorganization of real estate enterprises has constituted a vast bulk of reorganization proceedings in the courts of this country. The failure to restrict debt to proper limits with respect to earning power has been the chief cause of widespread defaults on real estate mortgages. It has been estimated that over 60% of the outstanding real estate bond issues in this country defaulted. The limited economic life of a piece of real estate is a factor which serves to emphasize the necessity of retiring debt even more than in the case of industrial enterprise. Usually an industrial company makes provision by way of depreciation reserves for replacing capital assets which have

become worn out or obsolete. Earnings set aside annually can be used to buy plant and equipment, enabling the enterprise to keep abreast of developments and to meet competition, thus living and growing with the times and prolonging its life indefinitely. These opportunities are not available to owners of real estate. Equipment can, of course, be replaced, but there is little that can be done to overcome the obsolescence of a building. If a building no longer attracts tenants because it is old or because of a shift of tenants to other and better neighborhoods, purchase of new equipment and major alterations are of only limited assistance in staving off eventual loss of income. The tempo of obsolescence increases with age. It is vital, therefore, that retirement of debt of a real estate company should be regular and sufficiently substantial to offset depreciation so that at the maturity date the debt may be retired or readily refunded and any plan of reorganization for such enterprises must be reasonably calculated to accomplish this objective.

The Securities and Exchange Commission on January 31, 1944, released an opinion in the matter of *In Re Senwest Corporation,* (Commerce Clearing House Bankruptcy Report No. 155) (February 11, 1944), containing the following significant language concerning feasibility of a plan of reorganization involving real estate:

> "In approving a plan of reorganization the Court is required by the provisions of Chapter X of the Bankruptcy Act to find that it is feasible. A definition of feasibility is the soundness of the proposed capital structure. If bonds are to be issued, there should be reasonable assurance that earnings will be sufficient in amount and stability to provide regular payments of interest. *In addition, particularly in the case of of a real estate company such as the debtor, where the chief asset has a limited economic life and funds are not set aside for its replacement, the soundness of the proposed capital structure also depends, in a*

> *large degree, on the bond issue being regularly reduced so that at maturity any remaining principal can be readily paid or refunded.*" (Italics ours.)

In Re Philadelphia & Western Railway Co., the Securities and Exchange Commission released an opinion on May 18, 1943, (Commerce Clearing House Bankruptcy Report No. 136) saying:

> "*If bonds are to be issued they should not exceed an amount on which interest can be paid regularly out of reasonably assured earnings, together with sufficient payment on principal so that at maturity the remaining bonds can be paid or readily refunded.*" (Italics ours.)

In the light of these tests, the plan here involved is, plainly, not feasible. If the past is any criterion, the debtor will not be able to meet its current obligations of interest, taxes, insurance, sinking fund deposits, trustee's fees, renewal and replacement of furniture and furnishings. No figures were presented to show the earnings of the building from 1928 to 1937, but it is apparent from the record of payment to bondholders and the necessity for reorganization in 1936, that the income was grossly insufficient to service the debt. From 1938 to 1940 (R. 235) the average gross income was slightly over $28,000.00 per annum. Average annual operating expenses for the period were about $15,000.00, leaving about $13,000.00 for the payment of taxes, which were about $3300.00 per year; interest of $6400.00 per year; insurance (not shown in the record but which runs about $1000.00 per year) and trustee's fees ($300.00 to $500.00 per year), making total estimated charges exceeding $11,000.00, and leaving a balance of $2000.00 for the sinking fund ($3500.00 required annually). There was an average annual deficit of at least $1500.00 per annum for the sinking fund and this without pro-

vision for replacement or renewals of furniture, fixtures and equipment.

McKey, an appraiser, testified the building has been literally "starved" so far as upkeep was concerned. He said the greater part of the furniture was installed when the building was built; that the carpeting needs renewal and replacement; that because of war conditions the building is now fully occupied, but in the post-war period this building will not attract unless it is modernized (R. 29). Depreciation of the personal property—a vital factor in a furnished apartment building—was ignored in valuation.

This building has never in any normal period been able to earn sufficient to meet the current commitments undertaken by this plan, a factor completely disregarded by the courts below. Until the war came and the housing shortage developed, this building was in constant difficulty.

Fourteen years of unsuccessful past performance constitutes a fairly definite indication that the debtor will not be able to meet its current obligations under the plan.

Periodic retirement of debt should exceed depreciation by a reasonable margin. The Referee found that the present market value of the property was $150,000.00 and its economic value $160,000.00 (R. 163), although there is no evidence to warrant this economic valuation. He found the building had an economic life of sixty years. If this finding be accepted (although there is no basis for it) then this building has a remaining economic life of forty-five years. Considering an economic valuation of $160,000.00 and a remaining life of forty-five years, and depreciating the property at 2¼% annually, it is apparent that depreciation would amount to about $3700.00 per annum as against debt retirement of $3500.00 per annum. On a market valuation of $150,000.00 depreciation would just about equal debt retirement.

A building of this character, however, has, at most, an economic life of fifty years. With a remaining life of thirty-five years its normal depreciation is about 3% annually. On an economic valuation of $160,000.00 the property will depreciate $4800.00 annually and debt retirement, if the plan succeeds, would be $3500.00 per annum. If the market value of $150,000.00 be accepted, then annual depreciation would be $4500.00 against debt retirement of $3500.00 a year. Physical depreciation is an absolute certainty. Retirement of debt under this plan is an uncertainty. The fact that during the past fourteen years the average retirement of debt has been approximately $1500.00 per annum compels the conclusion that future retirement will be substantially less than depreciation.

Will the Debtor be able to retire or refund the debt at the end of this second extension period? Here, again, the past earnings record of the building condemns the plan. The Court of Appeals concedes that, "*the ratio of debt to the value of property will be high,*" but declares that "it will not necessarily be so high as to make some new financial arrangement impossible or improbable that we may say as a matter of law that the plan is not feasible" (R. 236). The Court of Appeals states the test in the negative—"we cannot say the plan is not feasible." We submit that feasibility requires an affirmative test—reasonable probability that the plan will succeed. Under the opinions of this Court, the law does not contemplate a succession of experiments with investors' funds.

The original amount of the bond issue in 1928 was $165,-000.00. From 1928 to 1936, $8000.00 in bonds were retired or an average of $1000.00 per year. In 1936, the debt was $157,000.00 and the Debtor could not pay it. It asked for and obtained a six year extension under 77B. Under the 77B plan it agreed to retire $3500.00 in bonds annually or $21,000.00 over the six year period. From 1936 to 1942 (operating under the 77B plan) $15,800.00 in bonds were

retired or an average of $2500.00 per year. The record does not show whether these bonds were retired at par or whether the Debtor or indenture trustee was able to purchase the bonds at less than par. The 77B plan authorized the acquisition of bonds at the lowest tendered price. We venture the speculation that many of these bonds were retired at less than par and the Debtor had considerably less than $15,800.00 available for bond reirement. The 77B plan failed by over $5000.00 in debt retirement. How does the Debtor propose to achieve in the future what it has failed to accomplish over the past 14 years?

In our argument on whether the plan was "fair and equitable", we stated there was no legal warrant for reducing the interest rate from 7% to 4½% and at the same time permitting stockholder participation. If we are right and the interest rate of 7% must be paid, then this plan is rendered still further unfeasible because the Debtor will be required to pay bondholders, not 4½% per annum, but 7%, and with this additional annual obligation of about $3500.00 or $21,000.00 over 6 years the plan cannot possibly succeed even if extraordinary war conditions continued for another six years.

The confirmation of the plan by the courts below resulted from a hopeful optimism wholly unjustified by any realistic appreciation of the history of the Debtor. Current war earnings alone persuaded the lower courts to approve this plan as feasible. The past earnings, under the same management, spread over the record of many years' operations, were ignored. If any normal period be considered, it is not reasonable to expect that, under the plan, the Debtor will meet its current obligations and it is beyond the range of probability that the debt will be retired or refunded at the end of the second extension period. If, at each approach to the maturity of its funded obligations, a debtor gets ready to expire and the pulmotor of reorganization is summoned, then there will be little hope for investors

for the ultimate payment of obligations held by them within any reasonably expectable period. On the face of it, a first mortgage debt of $141,800.00 does not seem soundly secured by property, the market value of which, appraised during a period of high prices, is only $150,000.00.

The plan fails to meet the legal and practical tests of feasibility. The prospect of a third reorganization may be clearly envisioned. Of the debtor enterprise, it may be truly said that the "past is prologue."

IV.

At a hearing on the question of whether or not a plan should be approved for submission to creditors and stockholders pursuant to Section 174 of Chapter X of the Bankruptcy Act, there should be available to the Court and interested parties competent valuation data from disinterested sources relating to the debtor's property and earning capacity to the end that the Court may exercise its own "informed, independent judgment" concerning the fairness and feasibility of the plan and the interested parties may intelligently vote on the plan.

At a hearing before the Referee to determine whether or not the plan should be approved for submission to creditors and stockholders, we asked the Court to appoint a competent and disinterested appraiser to evaluate the property of the Debtor (R. 26) to assist the court and the interested parties in determining the value of the property, and at the same time we informed the court that no bondholders could afford the expense of an appraisal and unless the expense was defrayed by the estate, bondholders were at a disadvantage. Our petition was denied (R. 84).

In his report recommending the approval of the plan for submission the Referee made no finding of the value of the property (R. 107). His report asserts that Haynie, an employee of the indenture trustee and a member of the bondholders committee (formed by the indenture trustee), testified that in his opinion the property had a fair cash value of approximately $155,000.00. Haynie did not qualify as an expert and it did not appear that he made a study of the earning power of the building. He testified that he merely looked at the building in the morning in anticipation of coming to court in the afternoon and testifying as to its value (R. 21). His testimony was tantamount to a guess. The banks as indenture trustee has a personal stake in the plan. It receives fees and deposits. The Referee concluded that because the property was, in his opinion, worth more than $141,800.00 stockholder interests could not be disturbed, and that no showing was made by the objector that the plan was not fair and equitable, and feasible. The report recommending the approval of the plan makes no analysis of past or prospective earnings (R. 107). After the requisite consents had been obtained and at a hearing on confirmation the Referee heard evidence for the first time from three interested appraisers (R. 236).

Secs. 174 and 175 of Chapter X of the Bankruptcy Act provides for a hearing on a plan to determine whether it shall be submitted to creditors and stockholders. It is submitted that this hearing contemplates the presentation of full valuation data concerning the assets of the Debtor. A mere statement by an interested witness that the property is worth $155,000.00 without any analysis of earnings, operating expenses, depreciation data, taxes, condition of furniture and finishings, etc., is not the kind of evidence which should constitute the basis of a plan of reorganization. Full and disinterested information should be required by the Court before a plan is approved for

submission. The defect is not cured by hearings on confirmation. Not having the necessary information before confirmation, creditors could not intelligently vote on or determine whether the plan was fair and equitable, or feasible, and the Court could not exercise its independent judgment. The defect is vital. *Even the appraisals at the hearing on confirmation,* all produced by interested parties, were insufficient. Following were the opinions of the various appraisers:

Name of Appraiser	*Opinion of Valuation*	*Basis for Valuation*
Frank Mc McKey, appraiser for appellant	$139,550.00	Earning capacity
Ivar W. Turnquist, appraiser for debtor	150,000.00	Original cost less depreciation
Wilbur C. Haynie, appraiser for indenture trustee	155,000.00	Cash market value

Turnquist, the debtor's appraiser, testified that the building was worth $150,000.00 and *he reached that amount by figuring the original cost at $225,000.00 and allowing a depreciation of $75,000.00* (R. 43). Haynie, appraiser for the bank as indenture trustee, merely said the property was worth about $155,000.00. McKey, petitioner's appraiser, testified that the property was worth $139,550.00 (R. 33). McKey examined the building in detail, analyzed its past earnings record, taxes, insurance, operating expenses, necessity for renewals of furniture, furnishings and equipment, and said that a prudent investor would be justified in demanding a return of 8% to 9% on his investment in this property. McKey thus capitalized the building at $139,550.00. McKey's analysis is, we submit, the approach required by the *Consolidated Rock Products* case, 312 U. S. 510, where this Court said, p. 525:

"Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result."

Other valuations were not and are not predicated on the earning capacity of the building. Nor was an attempt made by them to capitalize the property on a fair return on investment. The Referee found the economic value of the property to be $160,000.00. How he reached that figure is not shown by the record (R. 163). The principle for which we are contending is that in these circumstances the District Court should have appointed an independent appraiser with directions to examine meticulously into the earning capacity of the building and to present his (the appraiser's) findings at a hearing on the question whether the pending plan should be approved for submission to the interested parties. Until such data is available, neither the Court nor interested parties can properly pass on the merits of this or any other plan of reorganization.

V.

The Court of Appeals and the District Court failed to follow the holding of this Court in American United Mutual Life Insurance Company v. City of Avon Park, 311 U. S. 138, in requiring the indenture trustee, the underwriter of the bond issue, to make a complete disclosure of its activities.

The record here discloses that the Chicago City Bank and Trust Company, indenture trustee, has acquired bonds totalling $11,100.00 (R. 85), and owns in other capacities over $6000.00 in bonds (R. 85-86). This is over 10% of

the bond issue. It was not disclosed to the Court or to bondholders how and when these bonds were acquired; how much was paid; the circumstances under which each individual purchase was made. Were any of the bonds purchased prior to the filing of these proceedings in anticipation of forestalling bondholders who might object to a further extension of the bond issue? Approximately $15,800.00 in bonds were retired from 1936 to 1942. Were any of these bonds held by the bank? Has the bank been engaged generally in the purchase and sale of these securities? Has it profited by these transactions?

The bank, the original underwriter of the issue, formed a bondholders' protective committee shortly before the default occurred, consisting of three of its own employees. Asked how the committee was formed, Haynie, an employee of the bank, said: "It was created by the three of us getting together in the Bank" (R. 21). Precisely the same procedure was followed in the 77B proceeding (R. 22). The committee then commenced to solicit bonds for deposit. Neither the committee nor the bank disclosed to bondholders that the bank had received compensation during the past six years and had the benefit of the deposit of funds. Nor was it disclosed that if a further extension of the bond issue was granted the bank expected to receive further compensation (R. 21). Neither was it disclosed that if default occurred in the bond issue the bank was entitled under the terms of the trust indenture to foreclosure fees and that its attorneys would also be entitled to fees. The bondholders' committee was dissolved when it appeared that the activities of the committee had violated the Securities Act of 1933 in failing to register the certificates of deposit. To obviate the difficulty, however, the individual members of the committee constituted themselves as "attorneys in fact" for the bondholders (R. 23). Counsel for the committee also represents the "attorneys in fact" and is the same counsel who filed the foreclosure

for the indenture trustee on the same date this instant proceeding was filed (R. 39). He drafted the plan (R. 39). The indenture trustee and the "attorneys in fact" have supported this plan (R. 23). They have actively opposed the application of this objector for an appraisal. They opposed the objections filed by this petitioner to the plan of reorganization; they opposed the application of this petitioner for an order requesting the Securities and Exchange Commission to participate in the proceeding; they failed and refused to file a list of bondholders until ordered by this Court to do so; (R. 83) they failed to call to the attention of the bondholders and the Court that the bonds and the trust indenture provided for the payment of 7% interest after maturity (May 10, 1942).

Why does the bank as indenture trustee advocate a further extension of the bonded indebtedness instead of a sale of the property at a time when the market for property of this character is most favorable? We asked Mr. Haynie, the bank's witness, to estimate the number of properties upon which the bank acts as indenture trustee (R. 35). The Referee sustained an objection to the question saying "It is indenture trustee on a lot of properties. I know that and every referee and every judge knows that. I don't want you to go into details." (R. 35). We believe we were entitled to ascertain the bank's personal interest in the plan and to show the bank has a vital and economic interest in continuing this and other trusteeships. While the return to the bank on a single building may be inconsequential, that return multiplied several hundred times from similar trusts produces substantial income, and, in addition, the bank's deposits swell and larger sums are available for loans and investment.

In *American United Mutual Life Insurance Company v. City of Avon Park*, 311 U. S. 138, this Court proclaimed some fundamental principles relating to the duties and

responsibilities of trustees which are applicable to this case, pp. 144-145:

> " * * Here the fiscal agent was acting in a dual capacity. While it was representing the City, it likewise purported to represent the interest of the bondholders. The very minimum requirement for fair dealing was the elementary obligation *of full disclosure of all its interests. And the burden was on it to show at least that such disclosure was made.* * * * " (Emphasis ours)
>
> " * * Where such investigation discloses the existence of unfair dealing, a breach of fiduciary obligation, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors from the encroachments of another, the court has ample power to adjust the remedy to meet the need. * * * *The requirement of full, unequivocal disclosure; the limitation of the vote to the amount paid for the securities; the separate classification of claimants; the complete subordination of some claims, indicate the range and type of power which a court of bankruptcy may exercise in these proceedings.* That power is ample for the exigencies of varying situations." (Emphasis ours)

And this Court further said in *Woods* v. *City National Bank & Trust Company of Chicago*, 312 U. S. 262, 266-267:

> " * * * *The indenture trustee represents all the bondholders;* the committee those who have given it authorizations—in this case about 50 per cent. Where the interests of majorities and minorities do not coincide, the interests of the indenture trustee and the committee will tend to be antognonistic. Beyond that is the fact that an indenture trustee closely affiliated with a committee shares the committee's conflicts of interests." (Emphasis ours)

We asked the District Court to conduct a full inquiry into the conduct and activities of the Chicago City Bank

and Trust Company as indenture trustee and to remove it (R. 152, 172). The District Court declined. The Court of Appeals ruled that the record does not disclose conflicting interests to warrant its removal.

Under the circumstances the Referee should have conducted a full inquiry into the activities of the Bank as indenture trustee, after which the Court should have determined what, if any, action it should take. As this Court said in the *City of Avon* case, *supra*, "The court has ample power to adjust the remedy to meet the need".

VI.

Chapter X, Section 216 (10) of the Bankruptcy Act authorizes the approval of a plan providing for a sale of the debtor's property at an upset price. Fidelity Assurance Association v. Sims, 318 U. S. 608, does not prohibit the approval or confirmation of such a plan.

We asserted before the Referee and the District Court that a favorable real estate market presently exists for the property involved, and that the plan should be modified to require a sale or to permit bondholders who desired payment to receive such payment. Commenting on this objection, the Referee stated that "Chapter X contemplates reorganization rather than liquidation" (R. 104).

Chapter X, Sec. 216 (10) provides that a plan of reorganization under this Chapter may include " * * * the sale of all or any part of the property, either subject to or free from any lien, at not less than a fair upset price, and the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein; * * * "

Fidelity Assurance Association v. *Sims*, 318 U. S. 608, has created doubt as to whether a plan of reorganiza-

tion may provide for the sale of the Debtor's property at an upset price. The Referee believed that the *Sims* case prohibited a sale of the Debtor's property. It is submitted the *Sims* case is not in contravention of the Statute. The *Sims* case involved the question whether the original petition for reorganiaztion was filed in good faith because at the outset of the proceedings it appeared unreasonable to expect that a plan of reorganization could be confirmed. It appeared that the petitioner's only hope was conversion of its assets into cash and a distribution of cash to the security holders. This, this Court said, was not good faith. The *Sims* case does not prohibit a sale under a plan of reorganization, and in view of the present favorable real estate market the lower Court erred in repudiating the suggestions for a plan involving a sale on the ground that it was liquidation rather than reorganization.

CONCLUSION.

We submit that the factors which warrant relief in this case are:

1. The opinion of the Circuit Court of Appeals for the Seventh Circuit holds that notwithstanding an interest rate of 7% is fixed in the bonds and the trust indenture as payable after maturity, a plan of reorganization may extend the maturity date of the debt, fix an interest rate lower than the contract rate and at the same time allow stockholder participation. The opinion departs from the "priority rule" as announced by this Court in the *Boyd* case and in the *Los Angeles Lumber Products* case, and calls for the exercise by this Court of its power of supervision. A decision on this subject is of vital importance in reorganization law. Literally thousands of trust indentures in Illinois provide for 7% interest rate after maturity. The rate is valid and legal under Illinois law. Plans have been con-

firmed in the Northern District of Illinois which uphold this after maturity interest rate. The ruling of the court below results in a clear confiscation of the bondholders' property right to the benefit of stockholders.

2. The opinion of the Circuit Court of Appeals for the Seventh Circuit departs from the accepted and usual course of procedure under Chapter X of the Bankruptcy Act and under the decisions of this Court in holding that a specific objection must be made by a creditor to a plan of reorganization as violating the *priority rule* or the objection is waived as to the entire class of creditors. It calls for the exercise by this court of its power of supervision.

3. The opinion of the Circuit Court of Appeals for the Seventh Circuit departs from the principle announced by this Court in *Group of Investors* v. *Milwaukee Railroad*, 318 U. S. 523, and *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, viz., that interest at the contract rate must be treated the same as principal and given the same priority as principal. The opinion calls for the exercise by this Court of its power of supervision.

4. The opinion of the Circuit Court of Appeals for the Seventh Circuit in upholding the plan as feasible ignores the poor past earnings record of the building, contrary to the holdings of this Court in *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, and relies entirely on war earnings contrary to *Group of Investors* v. *Milwaukee Railroad*, 318 U. S. 523. A decision by this Court on the question of feasibility of a plan of reorganization involving a real estate enterprise is of prime importance in federal reorganization law.

5. The opinion of the Circuit Court of Appeals for the Seventh Circuit ignores the requirement under Section 174 of Chapter X that there be available to the court and interested parties competent valuation data from disin-

terested sources relating to the debtor's property and earning power to determine whether or not a plan should be approved for submission to creditors and stockholders. The failure to observe this necessary procedural requirement of Chapter X operates to the disadvantage of the interested parties and the court. Without competent valuation data the Court cannot exercise its own "informed, independent judgment" and the interested parties cannot intelligently vote on the plan.

6. Chapter X, Section 216 (10) of the Bankruptcy Act expressly authorizes a plan for a sale at an upset price. Does *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608, prohibit such a plan? The question is in confusion and needs clarification.

Wherefore, it is earnestly urged that certiorari be granted by this Court, requiring the Circuit Court of Appeals for the Seventh Circuit to certify the record in this case to this Court for review and determination.

Respectfully submitted,

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(27)

IN THE

Supreme Court of the United States

October Term, 1944.

No. 1024

In the Matter of
WAERN BUILDING CORPORATION,
Debtor.

ERNEST MORRILL,
Petitioner,
vs.
WAERN BUILDING CORPORATION,
Respondent.

BRIEF OF RESPONDENTS IN OPPOSITION.

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BRIEF OF RESPONDENTS IN OPPOSITION.

STATEMENT OF THE CASE.

In Petitioner's brief (p. 2) it is stated that a statement of the matter involved has been fully presented on pages 2 to 6 of the petition, to which the Court is referred. Attention of the Court is respectfully called to the fact that under the heading "Statement of the Matter Involved" in the petition, pages 2, 3 and the first half of page 4 is pure argument and has no place under the Statement of the Case, but inasmuch as petitioner has inserted such arguments therein, we feel impelled to answer under the same

heading to correct any erroneous impressions which petitioner may have conveyed.

On pages 2 and 7 of the petition it is stated that the plan reduced the interest on the bonded indebtedness from 7% to 4½% and permitted stockholder participation. That is not so; the plan provided for the extension of the maturity of the bonds for six years, and the rate of 4½% was the average rate of interest which the bondholders had received for the six years prior to the date of extension under a former plan of reorganization. The 7% referred to is the rate specified in the indenture as the rate payable after maturity, but the bonds not having matured because of the extension agreement, the interest rate had never been 7%. The full priority rule was completely observed as will be more fully set forth below.

On pages 2 and 3 of the petition, it is argued that the opinion of the Circuit Court of Appeals precluding petitioner from raising the specific objection that the priority rights of the bondholders were affected by the plan's provision as to interest rates was erroneous because the trust indenture "is in evidence and clearly shows a violation of the priority rights of the bondholders." On the contrary by the very terms of the trust indenture there is no violation of the priority rights, and the writer of the opinion stated that even on the merits of the case there was no violation of any priority rights; moreover, such a specific objection could not be raised in an Appellate Court for the first time. This contention also will be argued fully below.

On pages 3 and 4 under "Statement of Matter Involved," petitioner cites several Illinois cases, and states that the ruling of the Court below is in conflict with the decision of the Courts of Illinois. None of the cases are remotely connected with the issue here involved. The cases cited on page 3 all hold that a mortgagee, upon foreclosure, is entitled to interest on the mortgage note at the contract rate

from the date of the note until the rendition of the decree, and after that date at the legal rate for the amount found due. The Illinois case cited on page 4 was reported in abstract only, and the Court on this point merely held that an accelerating clause in a note secured by a trust deed did not make the loan usurious. Such holdings are not in conflict with the decision of the Circuit Court of Appeals in this case.

On page 7 petitioner intimates that there is no equity for the Class A Preferred Stock. The Court, however, affirmatively determined there was an equity for such shareholders.

The allegation (p. 7) that the debtor's past record, over 14 years, demonstrates its incapacity to meet the requirements of the sinking fund payments, is not borne out by the evidence presented before the Referee. The plan is to be in effect for six years and it was amply shown that for the life of the plan the income of the property will be more than sufficient to meet all sinking fund requirements, and the Referee so found (R. 107).

ARGUMENT.

I.

A PLAN OF REORGANIZATION OF A SOLVENT CORPORATION WHICH PERMITS STOCKHOLDERS TO PARTICIPATE TO THE EXTENT OF THEIR EQUITY, AND WHICH AFFORDS BONDHOLDERS EVERY RIGHT WHICH THEY HAD PRIOR TO THE ADOPTION OF THE PLAN IS FAIR AND EQUITABLE AND DOES NOT VIOLATE THE "ABSOLUTE PRIORITY RULE."

To determine whether or not the "absolute priority rule" as cited by petitioner has been violated in a given plan of reorganization it is necessarily essential to determine the rights of the creditors both before the filing of the petition for reorganization, and their respective rights as given them under the plan.

Under the original plan of reorganization confirmed in 1936 the bonds and trust indenture provided that interest shall be payable at the rate of 4% per annum from May 10, 1936 to May 10, 1939, and at the rate of 5% per annum from May 10, 1939 to May 10, 1942. A clause as to an accelerated rate of interest of 7% after maturity was contained therein. The original plan also provided for common, Class A Preferred and Class B Preferred stockholders.

After hearings on valuation were had before the Referee in the present proceedings, the court determined that there was no equity for the Common and Class B Preferred Stock, and they were eliminated from any participation; it expressly determined that the Class A Preferred Stock did have an equity in the property and it was permitted to participate on the basis of such finding (R. 184-185). This finding, after deliberations and hearings on valuation, per-

mitting the stockholders to participate *only* to the extent of what was determined to be their equity is in full accord with the principle laid down in *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106. What the Court denounced in the plan submitted in that case was the fact that though the debtor was admittedly insolvent the creditors were compelled to surrender 23 per cent of the value of the enterprise to the stockholders.

The present plan extends the maturity date of the bonds for six years and provides for an interest rate of 4½%, which is the average rate of interest the bondholders received under the trust indenture and bonds up to the time of the filing of the petition herein. The plan further provides that *all* of the net rentals must be deposited with the indenture trustee and the trust indenture provides that any monies remaining after payment of operating costs, interest, etc. shall be deposited in the fund for the redemption of bonds (R. 62-63). As was said in the opinion of the Circuit Court of Appeals, "Any stockholder participation here is more nominal than real * * *." Thus it cannot be said that any rights of creditors are being cut down, since no payment of dividends or any other participation in the income by stockholders is permitted; for the life of the plan (to May 10, 1948) all of the earnings will be utilized for the benefit of the bondholders alone. There is no subordination whatever of the interests of any of the creditors to that of any of the stockholders.

The only real contention as to the plan's unfairness and inequitableness is that the bondholders, according to the illogical view of petitioners, were entitled to receive 7% interest if stockholders participated. The petitioner states in his brief (p. 6) that two of the three judges of the Court of Appeals apparently did not concur with the writer of the opinion that the priority rule was not violated. There is no support for that conclusion. All three of the judges

agreed that the petitioner was precluded from raising this question for the first time on review; so far as the result was concerned no more need have been said on this point. Judge Kerner, however, continued by pointing out, as his own view, that even if petitioner had not been so precluded the contention was unsound on its merits. There is no intimation in the opinion that the other judges disagreed with Judge Kerner's views; they merely stated that because the question had never been presented below they would give no consideration to the contention, and expressed no disagreement with Judge Kerner.

The 7% interest was payable, by the terms of the trust indenture and bonds, *after maturity*. The petitioner seeks to convey the impression that the bonds and trust indenture provide for 7% interest after May 10, 1942, and that this date is specifically recited in the clause wherein the accelerated rate of interest is mentioned; the recital is that the notes "shall bear interest after maturity at the rate of 7% per annum" (R. 56).

The rate of 4½% interest provided in the present plan is merely the average rate which the bondholders received under the indenture for the period of the original extension, and allows them the same return under the proposed extension as they received in the previous period. Nothing whatever is being taken from the bondholders for the benefit of the stockholders; the priority of the bondholders is maintained and the bondholders will receive the same rate of return after the plan is put in effect as they formerly did.

The plan simply provides that the existing first mortgage notes maturity dates shall be extended from May 10, 1942 to May 10, 1948. This is the foundation of the entire plan —the extension of the maturity date—and the original notes are in full force and effect except for the fact that they will mature in 1948 instead of 1942. Inasmuch as the notes will not have matured, by reason of the extension

agreement, it cannot logically be asserted that the interest rate provided for "after maturity" must be the rate which the bondholders must receive if stockholders participate. Certainly it cannot be contended that in the event of an extension it was contemplated that interest thereafter should be at the rate of 7%. The participation of the creditors under the plan is precisely the same as it was before the petition was filed; their priority is completely maintained, their return is precisely the same, and their position is preserved to the full amount of their principal and interest. They are in certainly as good a position as they were prior to the filing of the petition herein and certainly they cannot legitimately complain that they should be given rights to participate to an even greater degree than they did before the plan was proposed. It is only where participation by stockholders is permitted in excess of what is determined to be their equity, or where the creditors are deprived of the full compensatory rights which they formerly enjoyed and there is some scaling down of their interests in favor of stockholders that the priority rule is violated. The proposed plan does neither; the maturity is extended, and thus the bonds have not matured and the rate of 7% is payable only *after* maturity. Upon the approval and confirmation of the plan these bonds will not mature until 1948; the "after" maturity rate of 7% cannot apply before that date.

Petitioner attempts to argue that the Illinois court's decisions are somehow in conflict with the decision of the Court of Appeals on this point. An examination of the cases cited (*Schmisseur* v. *Rebhan*, 13 N. E. (2d) 627, 294 Ill. App. 172, 179; *Arneson* v. *Haldane*, 105 Ill. App. 589; *Carson* v. *Rebhan*, 13 N. E. (2d) 630, 294 Ill. App. 180, 183) discloses that all of these cases merely hold that the mortgagee, upon foreclosure, is entitled to interest on the mortgage note at the contract rate from the date of the note

until the rendition of the decree of foreclosure and after such date at the legal rate (5%) on the full amount found due. None of these cases deal with an accelerated interest rate of 7% after maturity, if provided in the note, and merely mention the "contract rate," whatever such rate may be. Indeed, the case of *Carson* v. *Rebhan* held that the interest should have been computed at 6%, the contract rate.

As for the statement in petitioner's brief, (p. 9) that several plans allowing 7% after maturity as fixed by bonds and mortgages have been approved in the District Court, neither the facts nor the opinions in these cases are set forth. Without the facts or opinions, asserting that certain plans were approved by a District Court can carry no weight whatever in the determination of the issue here presented.

Petitioner further cites the cases of *Group of Investors, et al.* v. *Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 318 U. S. 523, 546; *Consolidated Rock Products* v. *DuBois*, 312 U. S. 510, 527; and *Coder* v. *Arts*, 152 Fed. 943, 950 (C. C. A. 8th), as sustaining his contention that the 7% interest rate must be the rate provided for in the plan. None of these cases so hold; they merely hold that interest on secured claims could not be cut off or wiped out any more than the principal, if junior securities participate. The interest referred to, however, is interest unpaid on due dates regardless of whether such dates fell before or after the filing of the petition, and provisions for such interest must be included in the plan. This does not mean, however, as petitioner contends, that a provision in the original notes as to an accelerated rate of interest after maturity must be the interest rate which is to be included in the plan if stockholders participate, where the maturity of the notes is extended under the plan. In the proposed plan the right of the bondholders to interest accrued on the

bonds is recognized and given the same priority as the principal and payments of such interest have been made on each due date (R. 176 and 212).

In determining that a proposed plan was fair, equitable and feasible, the court in *In Re Central Forging Co.*, 38 F. Supp. 18, 19 (D. C. M. D. Pa., 1941), said the following with respect to the rights of bondholders:

> "It means that their rights must be so preserved that, if the reorganized company succeeds and profits, the first fruits of that success or profits will go to the bondholders, or if the reorganized company fails to succeed, the bondholders' contribution will be protected first."

In the plan here proposed the bondholders have been afforded full priority rights over the stockholders; all earnings for the life of the plan are to be utilized for their benefit; their position has been preserved to the full extent of their principal and interest; there is no derogation of their interests in favor of stockholders, and the plan is fair and equitable in fact and in law.

II.

WHERE A SPECIFIC OBJECTION TO A PLAN OF REORGANIZATION IS NOT RAISED BEFORE THE REFEREE OR THE DISTRICT COURT, THE OBJECTOR IS PRECLUDED FROM RAISING SUCH OBJECTION FOR THE FIRST TIME ON APPEAL.

Petitioner concedes that an objection may not ordinarily be raised for the first time in a reviewing court, but contends that in the case of a reorganization proceeding under the Bankruptcy Act he may for the first time offer specific objections to a plan despite the fact that such matter was never presented below. The contention seems to be that in reorganization proceedings the scope of the Circuit Court of Appeals' jurisdiction is broader than is the case in ordi-

nary litigation, and that different rules apply to such proceedings. Sections 47 and 48, Title 11 U. S. C. A., dealing with the jurisdiction of the Circuit Court of Appeals in bankruptcy matters, confer upon the Circuit Court of Appeals appellate jurisdiction only; these courts are not vested with original jurisdiction, and they have in bankruptcy proceedings, as in all other litigation, appellate jurisdiction only.

In *Amick* v. *Columbia Casualty Co.*, 101 F. (2) 984, 986 (C. C. A. 8th), the court said:

> "This court is not a court of bankruptcy. In bankruptcy proceedings its jurisdiction is purely appellate."

The function of an appellate tribunal is to review the proceedings below and to determine whether or not there was error in such proceedings. Certainly the court below cannot be said to have erred for failing to consider objections not presented to it. To hold otherwise would change the whole procedure before the Circuit Court of Appeals from review to an original inquiry.

It may well be that a judge has the duty of affirmatively determining whether or not a plan is fair, equitable and feasible despite lack of objections or evidence to the contrary. Where, however, objections are desired to be made to a proposed plan, the forum in which to make such objections is in the bankruptcy courts, which Congress has designated as the District Courts of the United States (11 U. S. C. A., Sec. 1). It would indeed be anomalous to permit an objector to refrain or refuse to offer specific objections to a proposed plan in the District Court, and then permit such objections to be introduced for the first time in a purely appellate tribunal.

The contention that the trust indenture being in evidence and that since "it was patent from an examination of this document that the rights of bondholders were violated by

the plan," it was not incumbent upon the objector to specifically point out the objection, is obviously not worthy of merit. In the first place, if the rights of bondholders were so patently violated by the plan, and if a mere reading of the trust indenture would so disclose, why did not petitioner, who throughout so actively resisted the confirmation of the plan, immediately discover such violation and call it to the attention of the court? The answer is that no violation of the rights of the bondholders is disclosed by the trust indenture. In his objection to the confirmation of the plan, petitioner listed nine specific objections to the fairness, equitableness and feasibility of the plan, yet failed to make any mention whatever as to the alleged violation of the rights of the bondholders in not receiving 7% interest under the plan (R. 153, 154). It is obvious that this objection was an afterthought on the part of petitioner; objections which could have been made, and were not, should be deemed to be waived and not permitted to be thrust in as an afterthought upon appeal.

The rule of appellate procedure denying parties the right to raise new issues and introduce new matters for the first time in the reviewing courts extends to every field in which the courts exercise purely appellate jurisdiction. No case cited by appellant is authority otherwise. To exclude from this rule the reviewing of plans of reorganization would be to cause untold confusion; the courts of appeals would be placed in the position of deciding issues "de novo" and would, in effect, change the whole procedure before such courts from review to original inquiries. The decisions cited by petitioner do not sanction such procedure, nor is it contemplated by the provisions of Chapter X of the Bankruptcy Act.

III.

IN ITS DETERMINATION THAT THE PROPOSED PLAN WAS FEASIBLE THE COURT BELOW CONSIDERED ALL THE REQUIREMENTS ESSENTIAL TO ESTABLISH FEASIBILITY, INCLUDING THAT OF ANTICIPATED EARNINGS FOR THE LIFE OF THE PLAN, AND THE PLAN MEETS ALL REQUIREMENTS OF FEASIBILITY NECESSARY UNDER CHAPTER X.

Whether a proposed plan of reorganization is feasible or not is a question of fact to be determined by the court after due hearings, and only in a case of clear mistake will the findings of the court below as to feasibility be set aside. As was said by the court in the case of *In Re Penfield Distilling Co.*, 131 F. (2) 694 (C. C. A. 6th), on page 694:

> "Findings of fact by a referee in bankruptcy, confirmed by the District Judge, will not be set aside, on appeal, on anything less than a demonstration of plain mistake."

In *Wayne United Gas Co.* v. *Owen-Illinois Glass Co.*, (C. C. A. 4th), 91 F. (2) 827, 831, the court said:

> "The findings of the court below with respect to the good faith of the debtor in the filing of the petition, *the feasibility of the plan therein proposed*, and the unfairness of that plan to first mortgage bondholders are findings of fact, which we will not disturb unless clearly wrong." (Emphasis supplied.)

The question of feasibility then resolves itself into whether there was "plain mistake" on the part of the court, and that it was "clearly wrong" in determining that the plan was feasible. Having asserted it, the petitioner has the burden of demonstrating that, in the light of the evidence, there is no reasonable possibility under which the plan could succeed. A review of the evidence adduced at the hearings, however, clearly shows that there was more than ample grounds to support the referee's and the court's determination of feasibility.

In arriving at his findings, the referee had before him the records of operations for the previous five years (Tr. 162); he had before him the testimony of Wilbur R. Haynie who had long experience in the reorganization of real estate bond issues, and in the operation and appraisal of real estate (R. 20-23); he had the testimony of Ivan W. Turnquist who had been in the real estate business for twenty-three years and had made appraisals for the H. O. L. C. (R. 40-43). The Referee was sufficiently informed to determine the amounts necessary to reasonably assure success of the plan, and the reasonable assurance that such funds would be available from the earnings of the property.

The test of whether a plan is feasible is not solely whether the corporation made expected profits in prior years. If this were true the relief for which Chapter X was evolved would be non-existent, since a debtor could never have a plan approved if its past earning record had not met expectations, and it is precisely for that type of debtor that Chapter X was brought into existence. *Consolidated Rock Products* v. *DuBois*, 312 U. S. 510, requires an inquiry as to *expected* earnings which may reasonably be anticipated for the life of the plan; where such an inquiry is made, and the Referee and the Court determine *after* such inquiry that the reasonably anticipatable earnings are ample to meet all requirements of the plan, the test of earning capacity as determinable of a plan's feasibility is met. The court must look to the future as to whether a plan has reasonable assurance of success—not merely to the past.

There can be no question but that the property's indicated net earnings will be sufficient to meet the interim requirements of the plan. The maturity of the first mortgage notes is extended to May 10, 1948, and on the basis of present and prospective earnings, interest payments can be met when due for the life of the extension. Under more adverse economic conditions, in the six years prior to the

filing of the petition herein, no default was made at any time as to interest payments, and it surely cannot be seriously contended that such payments cannot be met in the next six years. The Referee further found, and his finding was confirmed by the court, that not only $3500.00 per annum would be available for retirement purposes, but that there will be, in all probability, $36,000.00 available for amortization of bonds during the six year life of the proposed plan of reorganization (R. 107). Since no dividend payments are required by the plan, the test prescribed by appellant's authorities—that earnings be reasonably expected to meet interest and dividend requirements—is more than fully met by the plan.

It must be remembered that for some years in the past there has been no building of housing accommodations, except in a few isolated instances for war workers which type of housing is not in competition with the property here concerned, and that for an undetermined time in the future no such building will be resumed, and that it therefore can assuredly be reasonably expected that the present annual income should be maintained for the life of the plan. This is not using war earnings as the basis of determining whether the plan is feasible; it is merely determining that in the light of existing conditions and the foreseeable future, present earnings will at least continue until May 10, 1948, the termination date of the plan. The termination of the present war cannot immediately affect the income of this property since, as has been noted, the conditions permitting present earnings will persist for some time beyond the ending of the war. Furthermore, the court will note that rents, due to emergency legislation, have been frozen, and because of the prevalence of one year leases, the date applicable is usually October 1, or May 1, 1941. Without such legislation there is no doubt that rents would be considerably higher, and upon the lifting of such rent

ceilings, it may well be that rents would seek their natural levels and increase the income of the property even beyond present levels.

The fact that use of the present earnings as an indication of feasibility may not be sanctioned under some circumstances cannot be made the basis of a sweeping assumption that such earnings cannot, in other circumstances, be reasonably expected to continue for the life of a proposed plan of reorganization. As was said in *In Re Central Forging Co.* (D. C. M. D. Pa.), 38 F. Supp. 18, page 19:

> "In the determination of what is fair and equitable and feasible, the facts of each case must be considered, and cases which bear a superficial similarity may not present the same problem at all."

To the question, "Will the debtor be able to retire or refund the debt at the end of this second extension period?" the answer is that the evidence indicated it would; the Referee found it would; the District Court believed it would; the Circuit Court of Appeals believed it would. There need be no provision in the plan guaranteeing that creditors will be paid in full at the end of the period of extension. In the case of *In Re Gibson Hotels* (D. C. S. D. W. Va.), 24 F. Supp. 859, on page 864, the court said:

> "But in order for a reorganization plan to be feasible, it is not necessary that there should be some guarantee that the creditors will be paid in full, without question, within a specified period. Nothing in the statute requires such a guarantee. * * *"

The test is not absolute guarantee of success beyond any possibility of doubt; a reasonable belief is all that is required. On this point the language of the court in *Rauscher v. Northwest Cities Gas Co.*, 46 F. Supp. 49 (D. C. Ark.), on page 51, is pertinent. The court said:

> "My problem, however, is not to determine whether beyond peradventure the plan will succeed. My task

> is to determine whether it probably can succeed. The word 'feasible' does not connote absolute assurance of success. It means reasonable assurance of success. * * * The only standard by which a reorganized Northwest's possibility of success may be appraised is the history of its operations in the recent past *in conjunction with the probable changes in conditions during the not too distant future.*" (Emphasis ours.)

Foreseeable future conditions, especially where a plan is to operate for a limited time, must be taken in consideration in determining the probable success of a plan. The life of the plan is until 1948. There is no reason to believe that, so far as can be foreseen, the same difficulties will beset the debtor for the life of the plan as were encountered in the past. It is precisely because of the present economic situation that the debtor sought to reorganize with the highly probable expectation of success, and such economic conditions as can be foreseen in the immediate future are largely in favor of the plan's feasibility.

Furthermore, where a plan is not unfair and not inequitable as a matter of law, and where only the factual question of feasibility is involved, the fact that an overwhelming percentage of creditors, the parties primarily concerned, consent to the plan, should be given considerable weight. Consents were filed herein by the holders of $107,100 of an aggregate amount of $123,600 of claims filed (R. 204). The only active objector is the petitioner who holds one $1,000 bond. The very spirit and purpose of Chapter X is to prevent a single recalcitrant party from blocking a plan deemed desirable by a tremendous percentage of creditors of the same class.

As was said by the Court in *In Re A. C. Hotel Co.* (C. C. A. 7th), 93 F. (2) 841, 843:

> "However, the expressed preference of a large percentage of all claims of security-holders interested in

the property, especially if well-considered and intelligently reached, should not be lightly set aside."

In the case of *In Re Gibson Hotels* (D. C. S. D. W. Va.), 24 F. Supp. 859, 864, the court said:

> "In passing upon feasibility of a reorganization plan a court should not lightly set aside express preference of a large percentage of all claims or interested security-holders, especially if well considered and apparently intelligently reached."

Upon the question of fact of feasibility, where due consideration has been given to all essential factors, including past earnings, probable future earnings for the life of the plan, the foreseeable economic future, and the reasonable probability of success; and where the Referee, the District Court, and the Circuit Court of Appeals have all determined the plan is feasible, certainly it cannot be said that the plan is, in fact, not feasible.

The language of the Court in *In Re 333 North Michigan Avenue Building Corporation*, 84 F. (2) 936 (C. C. A. 7th), on page 943, may be well appropriate here:

> "It is urged by appellants that the plan is not feasible. That, of necessity, must depend upon the earning power of the property and future economic conditions. * * * What the property is, and what it has produced, is well known. What it will do in the future is, of course, problematical. The District Court held that there was reasonable ground for believing the plan would succeed. We concur in that view."

IV.

THE NECESSITY OF AN INDEPENDENT, FORMAL APPRAISAL IS WITHIN THE SOUND DISCRETION OF THE TRIAL COURT, AND WHERE THE DEBTOR'S PROPERTY CONSISTS OF A SINGLE PARCEL OF REAL ESTATE, AND THERE IS SUFFICIENT VALUATION DATA IN THE RECORD TO ENABLE THE COURT TO EXERCISE AN INFORMED JUDGMENT, IT IS JUSTIFIED IN CONFIRMING A PLAN WITHOUT REQUIRING AN INDEPENDENT APPRAISAL.

Whether or not the court should order an independent appraisal at the expense of the estate depends upon the facts of each proceeding. If the Referee or Court finds that without such an appraisal it cannot exercise its own informed, independent judgment then without question such an appraisal is entirely appropriate. It may well be that in the case of a complex, diversified enterprise an independent appraisal of a formal nature is essential, but where the enterprise involved is a single piece of property, and where sufficient information of a reliable nature is available, no such appraisal is necessary. Indeed, such appraisal may properly be held to be wrongful in adding another burden of expense to an already overburdened debtor.

This view is supported by this court in its holding in the case of *Consolidated Rock Products Co.* v. *DuBois,* 112 U. S. 510, 527. The Court said:

> "The Circuit Court of Appeals correctly left the matter of a formal appraisal to the discretion of the District Court. The extent and method of inquiry necessary for a valuation based on earning capacity are necessarily dependent on the facts of each case."

There is no basis for the contention that a formal appraisal of the property must be submitted to the court before it may approve a plan to be submitted to the creditors.

No authority to sustain this view is cited. So long as before the plan is confirmed by the court there is competent valuation data upon which the court can base an informed opinion, the requirements of the statute are satisfied.

Competent testimony was submitted by three appraisers as to the valuation of the debtor's property, ranging from $139,550 by the appraiser for the petitioner, to $155,000 by the appraiser produced by the Indenture Trustee. The appraiser for the petitioner arrived at his valuation by capitalizing earnings at from 8% to 9%, but admitted that if a buyer would take 7% for his investment, his valuation would be higher (R. 33). Mr. Turnquist, appraiser for the debtor, testified that the proper rate of return for a prudent investor on this type of property would be 5% to 6% (R. 43). The Referee in determining the economic value of the property used the very test of expected earning capacity which petitioner contends is the primary test sanctioned by this Court. It was not incumbent upon the Referee to accept the valuation submitted by any one or more of the appraisers, and he had not only the right, but the duty, to independently determine, from all available information in the record, the proper valuation based upon expected earning capacity, and upon what he independently determined to be a fair rate of capitalization. He had the right to consider that rents are currently frozen by present war time legislation in determining the factor capitalizing earnings when considering present income; and the likelihood of a lower rate being currently applied due to such frozen rentals in anticipation of a general rental increase when rent ceilings are lifted.

The Referee in his report stated:

> "That taking everything into consideration, *and based on what I regard at this time a fair capitalization of the prospective earnings of the debtor's real estate*, such real estate would have an economic value of at least $160,000." (R. 163.) (Emphasis supplied.)

On the question of the necessity of a formal appraisal the Circuit Court of Appeals in *In Re Georgian Hotel Corporation* (C. C. A. 7th), 82 F. (2) 917, on page 920, said:

> "Appellants assume to find impropriety in the fact that, prior to the adoption of the plan, no definite formal appraisal of the property was made. * * * There was testimony given as to the status of the property, the original cost of the plant, its probable replacement cost, the income derived and charges and upkeep, and other matters having direct bearing on the value of the property, and its future prospects. Such evidence was informative and helpful to the court in the exercise of its discretion. In view of the circumstances pointed out, the absence of a formal appraisal was not such an omission as should of itself condemn the plan."

The Referee in this proceeding had before him all necessary data, including probable earning capacity, to arrive at an informed judgment as to the value of the debtor's real estate (R. 160-163), and the court in confirming such valuation exercised a sound discretion.

V.

THE RECORD DISCLOSES NO CONFLICTING INTERESTS OF THE INDENTURE TRUSTEE, NOR FAILURE TO MAKE A COMPLETE DISCLOSURE OF ITS ACTIVITIES, AND THE HOLDING OF THIS COURT IN AMERICAN UNITED MUTUAL LIFE INSURANCE COMPANY v. CITY OF AVON PARK, 311 U. S. 138, HAS NO APPLICATION TO THE INDENTURE TRUSTEE HEREIN.

The only basis offered for any allegation that the Trustee Indenture occupied any such position as to require a delving into its activities with a view towards its removal is the fact that it owns a small percentage of the bonds in its individual capacity and in its capacity as trustee under certain trusts. We fail to see wherein the mere ownership of a small portion of the bonds will cause the trustee to be miscreant to its trust. The trustee's duties have always

been in behalf of the owners of the bonds, and the trustee never had and has not now any interest, financial or otherwise, to any others; it at no time had any obligation to anyone except bondholders. Indeed its ownership of some of the bonds makes its interest identical with the bondholders and may have even caused it to be more astute and cautious in protecting their interests.

No personal gain or advantage derived by the Indenture Trustee by the alleged activities and alleged non-disclosure is even remotely shown. The record shows by the sworn statement of the trustee that it held the notes owned by it for more than one year prior to May 10, 1942, so that there is no basis for the allegation that these bonds may have been purchased prior to the filing of these proceedings for the purpose of expediting the extension of the bond issue (R. 85-86). Nor did the activities of the committee in any way prejudice the rights of the bondholders. The letters asking for deposit were frank and open and fully disclosed the situation, and the bondholders were later informed that, due to the requirements of the Securities Act of 1933, the deposit agreement was revoked, and the members would act as attorneys in fact if so requested (R. 90-91).

The underlying objection to the Indenture Trustee's activities is that it approved the plan herein proposed, and lent its aid to its adoption. The plan was filed by the debtor corporation, although it is not denied that it was approved by the trustee which is agreeable to its consummation. If the plan is approved by the Trustee who believes it fair and workable, is there any reason why it should not consent to its confirmation? It may file a plan of its own if not satisfied with other plans submitted, but that is not to say that it cannot urge approval of a plan offered by the debtor which, in its opinion, is worthy of adoption, and is fair and equitable to all creditors. There

is but the lone assertion by a single objecting creditor that the plan is unfair and unfeasible, and that therefore approval of such a plan by the Indenture Trustee is tantamount to reprehensible conduct—an assertion which on its face reveals its inherent invalidity.

The case of *American United Mutual Life Insurance Company* v. *City of Avon Park*, 311 U. S. 138, upon which petitioner heavily relies as sustaining his contention as to the alleged non-disclosure on the part of the Indenture Trustee, is in no way analogous to the situation here. That case dealt with the disclosure to be made by a fiscal agent seeking approval of a plan worked out by it, and in which it actively attempted to secure consents. The court found that the fiscal agent had at least three financial stakes in the composition arrangement, if it were approved, and that without claims held by the agent and voted by it in favor of the plan, the necessary two-thirds consent would not have been obtained. In the present proceeding, however, the relationship of the Indenture Trustee to the bondholders was known to all concerned. The only financial interest the Indenture Trustee has in this plan, other than as owner of some of the bonds, is the usual compensation it may receive as such trustee. Surely the fact that it did not affirmatively notify each bondholder that it did and would receive such compensation is no basis for contending such non-disclosure as may be to the prejudice of the creditors. It is common knowledge that a bank acting as trustee under an indenture receives compensation therefor, and that such compensation is merely in payment for services rendered; furthermore, the trust indenture provided for such compensation (R. 76). Any corporate trustee acting in such capacity exacts the same fees, and it can safely be assumed that all the bondholders were well aware of such fact. Merely receiving such compensation is a far cry from having a personal financial stake in the plan itself, and in

securing definite financial benefits accruing from the provisions of an agreement between the debtor and the fiscal agent if the plan is approved, as was the situation in the City of Avon Park case. Furthermore, even without the bonds held by the bank, over 70% in amount of the owners of the bonds have individually signed consents to the plan of reorganization (R. 167).

Nor does the case of *Woods* v. *City National Bank & Trust Company of Chicago*, 312 U. S. 262, cited by petitioner, apply to the situation in the present proceedings. That case dealt with fees claimed by various parties, and it was merely held that where such claimants represent conflicting interests compensation will be denied. The conflicting interest which the court held reprehensible was that the committee which solicited the bondholders was composed of employees of the principal underwriters who were heavily interested in the equity. The Indenture Trustee herein, however, has no interest in the equity whatever, merely being a creditor to the extent of its ownership of the bonds of the debtor, and represents no conflicting interest of any nature.

The propriety of the type of inquiry demanded by petitioner, and the removal of the Indenture Trustee were certainly at most within the sound discretion of the trial court. Indeed, upon the record, with its complete lack of evidence of any kind of any misconduct, bad faith, or personal advantage on the part of the trustee, it would have been an abuse of discretion by the court to have so ordered. The case of *In Re Georgian Hotel*, 82 F. (2) 917 (C. C. A. 7th), while it dealt with the question of reorganization trustees and not indenture trustees, indicates the attitude of the court. On page 920 the court said:

> "Much is said in appellant's brief on the subject of the personnel of the original bondholder's committee and of its successors and of the trustees who are sug-

gested in the plan to take charge of the reorganized concern. * * * Again we fail to see wherein the court in this respect abused its discretion. If the trustees who may be constituted under the plan are recreant to their trust and fail to discharge their duties, anyone interested may, on application to the court, have an investigation and such relief as the nature of the case may require."

Certainly more is necessary to warrant an investigation and removal of an indenture trustee than a mere demand by a single objecting creditor, who has no evidence to offer in support of his demands, and who makes no showing whatsoever of any conflicting interests, bad faith, or prejudicial conduct.

VI.

IT IS NOT ERROR FOR A COURT TO REFUSE TO MODIFY A PLAN OF REORGANIZATION TO PROVIDE FOR AN OUTRIGHT SALE OF THE PROPERTY, WHERE THE ORIGINAL PLAN IS FAIR, EQUITABLE AND FEASIBLE AND HAS BEEN APPROVED BY AN OVERWHELMING PERCENTAGE OF THE CREDITORS.

The question involved in the present proceedings is not whether the court had the authority, under Chapter X, to provide for a sale of the property at an upset price; rather it is whether the court was in error in refusing to modify the plan to provide for such a sale. The holding of the court in *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608, is neither expressly nor impliedly involved here. There can be no contention that it is incumbent upon a court, when an objector to a plan desires it modified so as to order a sale of the property, to perforce immediately set aside the proposed plan and put in effect the proposed modification. The plan as confirmed by the court was fair and equitable to all; it contemplated the continuation of the enterprise for the benefit of all concerned; it provided a

fair rate of return for the creditors; it was approved by an overwhelming percentage of all the security-holders.

Where a proposed plan effectively secures the reorganization of a debtor corporation with all probability of the carrying out of the plan to successful completion, there is no need to modify the plan to one in which outright liquidation is contemplated. While it may be true that the Sims case does not prohibit a sale under a plan of reorganization, it is certainly not authority that a plan must involve a sale; the Referee undoubtedly considered that the plan adopted was more advantageous to all concerned than a liquidation, and that there was no need to give full consideration to a plan requiring the sale of the property.

Conclusion.

We conclude:

1. A plan of reorganization of a solvent corporation which permits stockholders to participate only to the extent of their equity, and which provides for an extension of the maturity date of outstanding bonds and provides for an interest rate equal to the return the bondholders received prior to the filing of the petition, is fair and equitable and does not violate or contravene the "absolute priority" rule. No holding in any case requires the rate of interest fixed in the bonds as payable after maturity to be the rate of interest which must be included in a plan, if stockholders participate, where the maturity date of the bonds is, under the plan, extended for a period of years.

2. The Circuit Court of Appeals is, under the Bankruptcy Act, a court of appellate jurisdiction only, and except where modified by statute the same rules of appellate procedure apply to appeals under the Bankruptcy Act as in any other case. Thus, where a specific objection to a plan of reorganization is not raised before the Referee on the District

Court, the objector is precluded from raising such objection for the first time on appeal.

3. Under the plan of reorganization herein, interest on the outstanding bonds has been afforded the same priority as the principal, and payment of all interest have been met on each due date.

4. In its determination that the proposed plan was feasible the court below considered all the requirements essential to establish feasibility, including that of anticipated earnings for the life of the plan, in accord with all decisions of this court and the requirements of Chapter X of the Bankruptcy Act.

5. The necessity of an independent, formal appraisal is within the sound discretion of the trial court, and where the debtor's property consists of a single piece of property and there is sufficient valuation data of a reliable nature before the court, there is no abuse of discretion in not requiring such an independent appraisal.

6. The record discloses no conflicting interests of the Indenture Trustee, and there has been no showing of any activities or alleged nondisclosure which could possibly prejudice the creditors.

7. The question as to whether the holding in *Fidelity Assurance Association* v. *Sims,* 318 U. S. 608, prohibits a plan from providing for the sale of the debtor's property at an upset price, is not here involved.

The judgment of the Circuit Court of Appeals for the Seventh Circuit is not in error; it is not in conflict with the decisions of the Illinois courts or of any other circuit; it is not in conflict with any decision of this court. The decision is in complete accord with all principles of corporate reorganization as reported by this court and the

various Circuit Courts of Appeals and District Courts. Hence the petition for certiorari ought to be denied.

Respectfully submitted,

Walter E. Wiles,
Counsel for Respondent, Chicago City Bank & Trust Company, Indenture Trustee.

Herman Barrington,
of counsel.

BRIEF FOR THE RESPONDENTS IN OPPOSITION

(28)

IN THE

Supreme Court of the United States

October Term, 1944.

No. 1024

In the Matter of
WAERN BUILDING CORPORATION,
Debtor.

ERNEST MORRILL,
Petitioner,
vs.
WAERN BUILDING CORPORATION,
Respondent.

BRIEF IN OPPOSITION OF WAERN BUILDING CORPORATION TO PETITION FOR WRIT OF CERTIORARI OF ERNEST MORRILL, PETITIONER.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Now comes Waern Building Corporation, debtor and respondent, and moves the court for leave to adopt the brief in opposition heretofore filed by Chicago City Bank & Trust Company, Indenture Trustee, respondent, to petition for writ of certiorari of Ernest Morrill, petitioner, and that same stand as and for the brief in opposition of Waern Building Corporation, debtor and respondent to the said petition for writ of certiorari of Ernest Morrill.

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REPLY BRIEF

(24)

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 1024

In the Matter of

WAERN BUILDING CORPORATION,
Debtor.

ERNEST MORRILL,
Petitioner,

vs.

WAERN BUILDING CORPORATION,
Respondent.

REPLY TO BRIEF OF RESPONDENTS IN OPPOSITION.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 1024

In the Matter of

WAERN BUILDING CORPORATION,

Debtor.

ERNEST MORRILL,

Petitioner,

vs.

WAERN BUILDING CORPORATION,

Respondent.

REPLY TO BRIEF OF RESPONDENTS IN OPPOSITION.

The brief of the Respondents in opposition to the Petition for Certiorari, predicated as it is upon certain fundamental misconceptions of both law and fact, constitutes, it is respectfully submitted, no answer to the position of petitioner.*

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* The brief is denominated "Brief of Respondents in Opposition", using the plural. The court will notice, however, that the brief is filed on behalf of only one respondent, *Chicago City Bank & Trust Company, Indenture Trustee.* The principal respondent, Waern Building Corporation, has not, up to the present writing, filed any brief of its own in opposition.

I.

Under Point I of Respondent's argument it is assumed that the stockholders of the debtor corporation were allowed to participate, under the plan of reorganization, because they possessed an equity, and it is assumed, moreover, that the bondholders were afforded every right which they had prior to the confirmation of the plan (Respondent's Br. 6, 7, 8). Whether or not the stockholders of the debtor possessed the thin margin of interest claimed for them under the unscientific testimony of the expert witnesses called to support the plan, in no manner touches the right of the bondholders to receive the full priority to which they are entitled under the terms of their bonds and under the trust indenture securing them.

The bare statement of the admitted facts will demonstrate the insufficiency of the admittedly precarious foundation of the stockholders' claim to an interest or equity in the debtor's assets. The property, a furnished apartment building, is now approximately 17 years old and, for the most part, has never been refurnished (R. 29). One witness for the Respondents, testifying as to value, was an employee of the same Respondent which submits herein the opposing brief. He had no experience as a real estate valuator (R. 21), and he testified that on the morning of the day on which he was called as a witness he "saw" the building. There is no evidence that he made any true examination either of its exterior or interior or that he based his opinion on its earning capacity (R. 21). This was Wilbur C. Haynie who stated that in his opinion the property had a cash market value of $155,000.00 The only other witness called by the supporters of the plan, and who makes any claim to expertness, was Ivar W. Turnquist, who testified that on the basis of original cost,

less depreciation, in his opinion the property had a value of $150,000.00. Turnquist, too, was probably produced by the active Respondent to the instant petition (R. 41). The witness, Frank M. McKey, called by petitioner, testified that, based upon earning capacity, the property, in his opinion, possessed a value of $139,550.00. This would render the debtor insolvent and would deny the stockholders participation in the plan. McKey was the only appraiser who observed that "meticulous regard for earning capacity" prescribed by this court as essential to the determination of the feasibility of the plan as well as its fairness. (*Consolidated Rock Products*, 312 U. S. 510, 525.)

Even if the Turnquist appraisal of $150,000.00, made upon the cost-less-depreciation basis, be accepted for the purpose of argument, there will be found to be no considerable residuum of equity for the stockholders. The principal indebtedness to the bondholders totals $141,800.00, leaving an over-plus of only $8,200.00 to take care of all the costs, fees and expenses of reorganization. If the valuations of the only two appraisers (McKey and Turnquist) who conducted any actual examination of the property be averaged at the point midway between the opposing appraisals, it will be found that the property would possess a value of $142,775.00, leaving $975.00 for the equity. Nothing is considered for replacement of equipment. It should be noted, in passing, that the Referee's statement that the property possessed an economic value of $160,000.00 finds no support whatsoever in the record (R. 163). Viewed realistically, it is self-apparent that no bank or other lending agency would make a loan of $141,800.00 on the property under any valuation appearing in this record.

While the foregoing consideration of the alleged equity in the stockholders is unnecessary to the enforcement or application of the full priority rule, it may serve as a back-

ground against which the rights of creditors may be observed.

The error into which the Circuit Court of Appeals fell was induced by the same argument which is now made to this Court, namely, that the creditors will receive 4½% interest under the plan and will receive as much as the *average rate* which they received under the old indebtedness. There were three rates of interest payable at three different periods under the terms of the bonds held by the creditors. One rate was 4% per annum from 1936 to 1939, another was the rate of 5% per annum from 1939 to 1942, and the third was 7% per annum after May 10, 1942, or, in other words, after maturity. *At the time the indebtedness matured and for three years prior thereto, the bondholders were entitled, not to an average of the interest receivable over the entire period of the indebtedness, but to the full rate of 5% a year.*

To average the interest rate is to re-make the contract of the parties. Debtor says bondholders will get the average of what they formerly received. That is not the test of fairness. That period is passed. The contract provides what they are entitled to receive after May 10, 1942—7% interest—and unless they receive that interest rate, they are not given full compensatory treatment in accordance with their contract. It is idle to argue, therefore, that the rights of the creditors are not being cut down, and to contend that no payment of dividends or other participation will be allowed to the stockholders until the bondholders are paid. *By this plan of reorganization the bondholders are deprived, immediately, of the full rate of interest to which they were entitled even prior to the maturity of the debt.* The court below, as do counsel for Respondents here, first reduced the interest rate and then contend that on the cut-down basis the bondholders will be paid first. The flaw in the argument is that it ignores

the point that the bondholders, by contract, were entitled to 7% interest after maturity and 5% interest before maturity. Of course, whatever is not paid to the bondholders is necessarily retained by the debtor itself, and if, unlikely as is such an eventuality, the debtor will some day pay this obligation in full, under the plan it will pay less to creditors in the total of principal and interest, than it was obliged to pay under the contract, before the present plan of reorganization. The stockholders participate in direct proportion to the amount by which the debtor is relieved from payment.

Aside from its unfairness, the danger of applying the scheme of averaging interest rates is apparent. Assume, for example, that a debtor, under an original bond issue, was obligated to pay 2% for the first three years, 4% for the next three years, and 6% for the last four years of a ten year period of indebtedness. Under the theory of the Court of Appeals a plan of reorganization providing for an average rate of interest of 4-1/5% would constitute full payment and priority to bondholders who for four years preceding maturity were entitled to 6% interest. If this same formula be applied to indebtednesses of greater magnitude, hundreds of thousands of dollars could and would be transferred from creditors to debtors.

Many specious arguments are addressed to the court in support of the Respondents' position. Such, for example, is the contention (Respondents' Br. 6) that the plan "allows them (the bondholders) the same return under the proposed extension as they received in the previous period." As has been said, the period immediately previous to the confirmation of the plan (from May 10, 1942 to Nov. 8, 1943) required 7% and not 4½% interest, and the period immediately preceding the date of maturity required 5% interest. Inadvertently, Respondents admit the position of the petitioner when it is said in their brief (page 7): "It

is only where participation by stockholders is permitted in excess of what is determined to be their equity, *or where the creditors are deprived of the full compensatory rights which they formerly enjoyed, and there is some scaling down of their interests in favor of stockholders that the priority rule is violated.*" (Italics ours.)

The attempted criticism of petitioner's citation of the Illinois cases holding that creditors are entitled to interest at contract rates is wholly untenable. Respondents state that these Illinois cases merely hold that the mortgagee, upon foreclosure, is entitled to interest on the mortgage note at the contract rate from the date of the note until the rendition of the decree of foreclosure (Respondents' Br. 7). Foreclosure, of course, is merely one of the remedies exercisable by the creditor, and under it the court proceeds to enforce the contract of the parties as such contracts are written just as the court is required to award judgment under the terms of the contract if suits were commenced upon the notes or bonds themselves.

The opinion of the Court of Appeals is in direct conflict with Illinois law which recognizes and enforces a contract obligation providing for the payment of interest at the rate of 7%. Moreover, a corporation may legally contract to pay *any* interest rate. Chapter 74, Section SEC 4 (Interest), Illinois Revised Statutes (1943), State Bar Association Edition provides:

> "In all written contracts it shall be lawful for the parties to stipulate or agree that seven (7) percent per annum, or any less sum of interest, shall be taken and paid upon every One Hundred (100) Dollars of money loaned * * * provided, however, with respect to money loaned to or in any manner due and owing from a corporation, the parties may stipulate or agree upon *any* rate of interest whatsoever. * * *" (Italics ours.)

Respondents' argument, moreover, that this court, in the *Milwaukee* case, 318 U. S. 573, and in the *Consolidated*

Rock Products case, 312 U. S. 510, "merely holds that interest on secured claims could not be cut off or wiped out any more than the principal if junior securities participate" (Respondents' Br. 8) again, in effect, concedes the correctness of petitioner's position. Respondents would restrict the word "participation" to present participation in the net income. As has been heretofore argued, stockholders here participate by electing directors who will manage the property of the debtor, and who will make leases, determine and govern operating costs and otherwise completely control the business. After all, the stockholders are the equity holders of the corporation. They, through their directors, control legal title. The corporation, for the purpose of reorganization, is the stockholders in their combined form, and it is the corporation which is relieved of part of its obligation under the present plan.

The underlying questions here are: Do the bondholders possess the right to receive 7% interest after May 10th, 1942? The answer, under the terms of their contract, must be in the affirmative. And, did the bondholders possess the right to receive 5% interest prior to maturity? Here, too, the answer must be in the affirmative. It follows inevitably, therefore, that their rights were violated by the plan of reorganization confirmed by the District Court.

The decision of the Court of Appeals below, if allowed to stand unreviewed and unquestioned by this court, may have far reaching consequences and may provide a pattern for future plans of reorganization where the results of the precedent may be quantatively more violative of the full priority rule than the plan in the instant case.

The question involved in this appeal is also vital in the administration of the reorganization provisions of the Bankruptcy Act. Under 77B, many bond issues involving real estate were extended. Many of these issues are again maturing and equity owners will undoubtedly again seek

relief in the federal courts. In Illinois, virtually all bonds and trust indentures provide for interest at 7% after maturity. As observed above, the rate is valid and is expressly authorized by Illinois statute. Under a plan of reorganization, may a debtor extend the maturity date of a debt, reduce the rate of interest fixed by the contract to an average rate previously paid, and at the same time participate in the plan? The District Courts will need guidance. The problem is of prime importance in federal reorganization law.

II.

The decision of the Court of Appeals, here sought to be reviewed, escaped, rather than decided, the important question presented to it for decision. The court was in agreement apparently only on the point that an objection specifically mentioning the full priority rule and completely outlining the position of petitioner should have been presented to the District Court. The petitioner did object to the plan on the basis that it was not fair or equitable and that it was not feasible. With due respect for the learned Judges below, it is submitted that the evasion of the principal point made upon the appeal was based upon a misconception of the true function of the District Court in a reorganization proceeding.

Respondents argue (Respondents' Br. 9) that petitioner's position is that in a reorganization proceeding the scope of the Circuit Court of Appeals jurisdiction is broader than in the case of ordinary litigation. Such is not petitioner's contention. The point which petitioner here seeks to make is that the Circuit Court of Appeals itself erred in refusing to review the action of the District Court. Whether or not, in such cases, an objection that the plan is not fair, equitable and feasible is sufficient, even though not complete in

every formal and technical aspect, presents a question of extreme importance in reorganization proceedings.

Regardless as to whether or not a formal and technically specific and complete objection was made to the plan on the basis of the full priority rule or, indeed, whether or not any objection at all was presented, the District Court was under the duty of protecting the rights of all creditors and others. The full performance of such duty required the court to perceive that, under the undisputed facts, a plan providing for an interest rate based upon averaging the entire period preceding maturity, which resulted in a new interest rate under the plan, less, even, than that which the debtor was obliged to pay before maturity, while at the same time allowing the stockholders an interest and participation in the corporate enterprise, necessarily contravened the repeatedly announced mandate of this court.

The Bankruptcy Act places upon the District Court a duty transcending its usual function as a judicial umpire. (Sec. 174 and Sec. 212 of Ch. X of the Bankruptcy Act.) From the very nature of reorganization proceedings, the court is required to do more than is usually necessary in causes involving contending litigants. As Mr. Justice Douglas said in the *Los Angeles Lumber Company* case, 308 U. S. 106, at pages 114-115:

> "The court is not merely a ministerial register of the vote of the several classes of security holders. All those interested in the estate are entitled to the court's protection. Accordingly, the fact that a vast majority of the security holders have approved a plan is not the test of whether the plan is a fair and equitable one * * * * A contrary conclusion in such case would make the judicial determination on the issue of fairness a mere formality and would effectively destroy the duty imposed by Congress on District Courts under Section 77B * * *. 'Every important determination by the court in receivership proceedings calls for an independent judgment.' "

Finletter, in "The Law of Bankruptcy Reorganization", says at page 474: "The court in effect is the guardian of those who do not assent to the proposal—a minority whose contract with debtor is being converted into some new and different right, protected only by the 'satisfaction' of the court."

The effect of the opinion of the Court below is to penalize, not alone the petitioner, but an entire class of bondholders, who own over $140,000.00 of the bonds. It is the function and duty of the District Court to protect the entire group of security holders.

In reorganization cases the judge is the boss of the reorganizers—not a mere dignified figure, passing only upon such questions as are forced upon his attention by vigorous counsel. Perhaps in a great majority of cases bondholders do not have lawyers. They receive communications from trustees, from creditor's committees and from banks, around the name of which is an aura of responsibility, recommending plans of reorganization. Consents from the uninformed and unpracticed security holders flow in as a matter of course. It was in realistic appreciation of such practical factors that Congress imposed upon the District Courts a duty somewhat larger and a vigilance somewhat sharper than is usual in the ordinary exercise of the judicial function. The court below failed to observe that such duty and vigilence do not come into being only under the pressure of objection.

III.

In Point III of petitioner's brief in support of his petition for certiorari, it was argued that the courts below disregarded the test of feasibility laid down by this court to the effect that the debtor's earning capacity is the most important criterion in determing feasibility. It was pointed

out (petitioner's brief Page 14 *et seq.*) that this court has said that whether or not earnings may reasonably be expected to meet interest and dividend requirements of the new securities is the *sine quo non* to the determination of the integrity and practicability of the new capital structure. And this court has said that the necessity for such an inquiry is made the more necessary by a past record of poor earnings (*Consolidated Rock Products* v. *DuBois,* 312 U. S. 510, 525, 526). Furthermore, in a recent case, the court pointed out that it cannot be assumed that the figures of war earnings can serve as a test for the indefinite future; that it is known from past experience that the upswing of business induced by war is likely to be followed by an aftermath in which conditions may be worse than before; that "the bulge of war earnings, *per se*" is unreliable for use as a norm unless history is to be ignored; and that numerous other considerations, present here as in former periods, make them suspect as a standard for any reasonably likely future, normal year. *Milwaukee Railroad* case, 318 U. S. 523, 543.

It would seem that the court must be impressed with the negative, hesitant statement of the opinion of the Court of Appeals when it said: "Though the ratio of debt to the value of the property will be high, *it will not necessarily be so high* as to make some new financial arrangement *impossible or so improbable* that we may say as a matter of law that the plan is not feasible (R. 238). This statement, it will be observed, came after the discussion by the court of the evidence as to the feasibility of the plan. If a court were moved to approve plans of reorganization because they are not shown to be impossible or improbable of success, then any plan which has the good fortune to receive the recommendation of a referee is approvable and confirmable. What is contended here is that the Circuit Court of Appeals, in reviewing the action of the Referee and the District Judge, did not observe the normal earning

capacity test of feasibility in passing upon the action of the District Court. In such cases there is sometimes a vicious pyramiding of error. The district judge will not change the findings of the referee if there is any basis whatsoever, however weak, for such findings, and the Circuit Court of Appeals will refuse to review the action of the district judge, as to the facts, upon the ground that the lower court is best qualified to find the facts, having the opportunity to observe the witnesses testifying on behalf of the several contenders. The District Judge had the same cold facts and figures before him as the referee and the Court of Appeals was similarly situated.

In the opinion of the court below the effect of complete occupancy of the debtor's property due to a shortage of habitable quarters in defense areas, is set out in a table (R. 235). In 1938 and in 1939 the gross rents received was $28,000 and $28,100 respectively, while the respective operating expenses were $15,000 and $14,800. In 1943 the gross rentals (designated as a "crude figure") were $33,000 with the operating expense $16,000. Thus will be seen an increase in rents of approximately $5000 in 1943 over 1938—an increase in income of approximately eighteen per cent.

The plan under consideration requires the debtor to retire $3,500 in bonds annually. The debtor has never in any past period been able to meet this requirement. From 1928 to 1936, $8,000 in bonds were retired, or an average of $1,000 per year. From 1936 to 1942, $15,200 in bonds were retired at a cost of $11,443.25 (R. 45). During the entire period of 14 years, $21,200 in bonds were retired, or an average amount of $1,500 per annum. How does the debtor propose to achieve in the future what it has failed to accomplish in the past? As pointed out in our original brief (P. 19) retirement of debt, even if the plan succeeds, will be substantially less than normal de-

preciation of the property. Furthermore, as pointed out, the 77B plan failed by over $5,000 in debt retirement.

The debtor declares that with the elimination of the rent freeze, "it may well be that the rents would seek their natural levels and increase the income of the property even beyond present levels." What is the "natural" level of rents on the property in question? Its record of earnings over the first fourteen years of its existence (1928 to 1942) conclusively demonstrates that its earnings were insufficient to fulfill the requirements of the present plan. There is nothing in the forseeable future and nothing in this record which justifies the naive optimism of the proponents of the plan. Moreover, no answer is made by respondents to petitioner's point (Petitioner's Br. 20-21) that there is nothing in the past record of the enterprise which indicates that the Debtor will be able to retire or refund the debt at the end of this proposed, second, extension period.

Respondents argue that it is not the past earning record alone which determines future earning capacity. As this court has said, however, the poor earnings record of an enterprise in the past makes all the more essential a close examination of reasonably anticipatable earnings. It is undisputed that the debtor enterprise, in fourteen years of its existence has never been able to earn enough to satisfy the requirements of its funded indebtedness. This is the second trip to the courts for relief and reorganization. The same management will continue to operate. The business conducted by the debtor is a furnished apartment building requiring close management and constant service to the guests or tenants. One very large capital element, *i.e.*, equipment, was completely ignored by the sponsors of the plan. Haynie, employed by the indenture trustee, merely testified that he "saw" the building, giving the court no information as to the condition of the equipment. Turn-

quist (appraiser for debtor) testified (R. 41) that he had "no opinion as to the value of the furniture at the present time" and that he didn't have an opinion as to the remaining life of the furniture in the building. McKey, the only witness who testified to the equipment necessary to operate a furnished apartment building, said that while the building "is in wonderful condition as far as cleanliness is concerned," stated that he thought that the "building had been starved as far as maintenance is concerned." Furthermore, he testified that he would say that the greater portion of the furniture and carpeting "was in there when the building was built." "Within the next five years," he said, "most of it would probably have to be renewed if you are going to build the building up to what you call a first grade building" (R. 29).

Based upon the factor of essential equipment alone, it is difficult to perceive how the court could accurately estimate probable future earning capacity or earnings which may reasonably be anticipated. While quoting general figures of income and expense there is nothing in the record which indicates that the Referee and the District Judge were given that detail of information which is necessary soundly to appraise the future. Even in one of the cases cited by respondent, *Rauscher* v. *Northwest Cities Gas Co.*, 46 Fed. Sub. 49 (D. C. Ark.), the court said: "The word 'feasible' does not connote absolute assurance of success. *It means reasonable assurance of success.*" (Italics ours.) (Respondent's Br., 15-16.)

Appealing to this court as they appealed to the court below, the respondents urge that consents were filed herein by the holders of \$107,000.00 of an aggregate amount of \$123,600.00 of claims filed. The unpaid bonds, however, total, in principal amount, \$141,800.00. The only active objector, say the respondents, is the petitioner, who holds one \$1000.00 bond. (Respondent's Br., 16.) The small

interest of the objector, coupled with the large percentage of consenting creditors, is urged upon this court, as it was below, as a controlling factor in considering the objections of petitioner to the plan. This argument runs directly counter to the decision of this court in *Los Angeles Lumber Company*, Case 308, U. S. 106, where Mr. Justice Douglas delivering the opinion of the court said at page 114:

> "It should be stated that where a plan is not fair and equitable as a matter of law it cannot be approved by the court even though the percentage of the various classes of security holders required by Section 77B (f) for confirmation of the plan consented. * * *
>
> Hence, in this case, the fact that 92.81% of the amount of bonds, 99.75% of Class A stock, and 90% of the Class B stock have approved the plan, *is as immaterial on the basic issue of its fairness as is the fact that the petitioners own only $18,500.00 face amount of a large bond issue.* * * *" (Italics ours.)

In the *Los Angeles Lumber Company* case the $18,500.00 of bonds owned by the petitioners constituted a smaller fraction of the total indebtedness than the $1000.00 bond owned by petitioner here. The argument, of course, is an argument of convenience. Approached from a practical standpoint, it is well known that consents to plans of reorganization by widely scattered creditors are the product of well oiled machinery of banks and trust companies and creditors' committees experienced in the business of reorganization.

We have examined all of the decisions cited by the Indenture Trustee under its Point III. In the light of the tests prescribed by this Court in the *Los Angeles Lumber* case, 308 U. S. 106, and *Consolidated Rock Products Co.* v. *Dubois*, 312 U. S. 510, none of the Respondents' cited cases (all decided before *Los Angeles Lumber* and *DuBois* cases) is pertinent or applicable here.

IV.

The practice of the courts in procuring independent appraisals, or any appraisals, *after* the plan has been submitted to creditors for approval should be condemned. The burden of respondent's argument in answer to petitioner's Point IV, to the effect that the District Court should have appointed a competent and disinterested appraiser to evaluate the property in advance of the submission of the plan to creditors, is that "so long *as before the plan is confirmed* by the court there is competent valuation data upon which the court can base an informed opinion, the requirements of the statute are satisfied." (Respondent's Br. 19.)

Section 174 of Chapter X of the Bankruptcy Act provides that "the Judge shall enter an order approving the plan or plans * * * which are fair and equitable and feasible * * *." This means that the court must exercise an independent judgment. The statute contemplates a hearing on plans *before* submission. A "hearing" presupposes such a disclosure of facts as will determine whether or not the plan is fair, equitable, and feasible. How, it may be inquired, can the court exercise an informed and independent judgment without enough information to enable it to say that the plan sufficiently appears to be fair and equitable and feasible as to entitle it to submission to them whose consents must be obtained? To say, as do the respondents here, that it is enough for the court to acquire such information prior to confirmation, is to nullify the purpose of the statute in requiring a hearing before submission. Such an impractical and far-fetched construction of the Act gets the cart before the horse. In effect, the respondents contend that the plan should be submitted to the creditors, the consents obtained and *thereafter examined to ascertain if the plan should have been*

submitted and should have been consented to by the creditors.

If creditors do consent they are moved largely by the persuading stamp of approval of the District Judge. The order approving the present plan for submission to creditors provided "It further appearing that said plan of reorganization, as amended, complies with the provision of Section 216 of the Bankruptcy Act of 1938 *and that it is fair, equitable and feasible.* (Emphasis supplied.) It is therefore ordered that the report of the Referee "is hereby approved" (R. 119). The Referee found "that the debtor's proposed plan of reorganization * * * is fair, equitable and feasible, and may be approved by your Honor pursuant to the provisions of Section 174 of Chapter X of the Bankruptcy Act" (R. 108).

The notice sent out to all creditors and shareholders opened with the language: "Notice is hereby given that an order was entered by the above entitled court in the above entitled cause on November 12, 1942, *approving a Plan of Reorganization*, as amended, proposed in the above cause by the Debtor as fair, equitable and feasible and in compliance with Section 216 of the Bankruptcy Act of 1938 * * *" (R. 121). With such authoritative language of approval what will an ordinary creditor do but consent to the plan?

It is plain, therefore, that it is not enough for the Court to gather competent valuation data at any time before the plan is confirmed. One of the very purposes of the hearing on plans prior to submission is to enable the court to arrive at an independent judgment before consent of creditors and stockholders is sought, especially when that seeking is accompanied by official language of approval.

One of the most important elements of fact which the court should take into consideration is the determination

of value which necessarily involves the consideration of earning capacity. Especially is an accurate valuation necessary in the case of a real estate corporation, because value determines what, in terms of money, the creditors will receive and when and under what conditions they will be paid.

Petitioner urges that the action of the District Court in contenting itself with examining valuation data after the submission of the plan and after consents have been obtained presents a procedural inaccuracy and error of grave import affecting, as it does, the substantial rights of creditors. This, it is respectfully urged, should not be sanctioned by this Court and given the dignity of even temporary precedent by the denial of certiorari.

On the contrary the prime importance of a complete hearing on a plan of reorganization before submission to security holders should be the subject of definite pronouncement by this Court.

V.

In answer to petitioner's Point V, to the effect that the failure of the District Court to compel the Indenture Trustee to make a complete disclosure of its activities constituted an error which the Court of Appeals failed to correct, the respondents argue (Respondents' Br. 20) that the record discloses no conflicting interests of the Indenture Trustee nor any failure by it to make a complete disclosure of its activities. In petitioner's brief in support of this application for certiorari, the Court's attention was called to its former opinion in *Woods* v. *City National Bank and Trust Company of Chicago*, 312 U. S. 362, and *American United Mutual Life Insurance Company* v. *City of Avon Park*, 311 U. S. 138, in each of which opinions the Court not only questions the propriety of a trustee acting in a dual capacity, but, also, insists that the

minimum requirement for fair dealing in such cases is the elementary obligation of full disclosure of all of such trustee's interests.

The Indenture Trustee in the case at bar is chargeable with a rigid singleness of purpose in protecting its *cestuis*, the bondholders. Obviously, if such a trustee not only possesses an individual interest in ownership of bonds, but also actively co-operates in the proposal, approval and confirmation of the *Debtor's* Plan of Reorganization, it performs a dual and triple function and participates in the representation of conflicting interests. All of this is present in the case at bar.

When it is remembered that consents and approval by creditors and stockholders are necessary prerequisites to final confirmation, the activities of the Indenture Trustee, in its active sponsorship of the Debtor's Plan, become significant. Certainly the interests of the Debtor and the interests of the bondholders are necessarily in opposition. And yet, so far as the record discloses, the bondholders were never advised as to the acts and conduct of their Trustee in connection with the reorganization proceedings in the District Court.

An effort was made by petitioner to show that it is this indenture trustee's policy to promote extensions of mortgage debts previously underwritten by it because such extensions perpetuate trusts to the financial benefit of the trustee. This effort was promptly suppressed by the Referee who said, "It (the present respondent) is indenture trustee on a lot of properties. I know that and every referee and every judge knows that. I don't want you to go into details" (R. 35).

No one at all familiar with this record could fail to perceive how far the Indenture Trustee strayed from the circumscribed field of its lawful place as trustee. It did not

and could not, under the facts, observe that quality of disinterestedness which is a necessary and inherent part of trusteeship.

Two officers and one employee of the Indenture Trustee, without request from any bondholder, formed the original Bondholders' Committee (R. 21). The original communication of this Committee to the bondholders (Bondholders' Exhibit 1, R. 44-46) stated that the Committee had been created by a deposit agreement, and then announced what was termed a "program." In this program, the communication stated, "the owners have tentatively suggested a further renewal, say for another six years, with interest at the rate of 4½% per annum (which is the average rate of interest paid during the last six years); and with a continuance of the provision for sinking fund deposits, to be used for the purchase and retirement of the notes. The Committee feels that this proposal has much in its favor, for not only does it offer an attractive rate of interest to those noteholders who look chiefly to the income from their investments, but it will also provide frequent opportunity to those seeking to liquidate their holdings, whereby they may do so without undue sacrifice of principal."

The letter to the bondholders then went on to say that the Committee would be very happy to work with them. A deposit of the bonds was sought, and a deposit agreement (giving the Committee authority to adopt *any* plan, R. 47), making the deposit irrevocable, without the written consent of the Committee, proceeded to grant complete power to the Committee over the interests of the depositing bondholders (R. 46-48).

This Committee was dissolved on the complaint of the Securities and Exchange Commission because it issued but failed to register certificates of deposits as required by the Securities Act of 1933. The deposit of the bonds was again solicited by the same three men who constituted the Bondholdes' Committee, who, under the new scheme,

sought the deposits by requesting appointment as "attorneys in fact" (R. 52). As had been said, these individuals were Francis J. Burke, Vice-President of the Indenture Trustee; Arthur G. Rathje, President of the Indenture Trustee; and Wilbur R. Haynie, an employee of the Indenture Trustee, in charge of the servicing of bond issues and liquidation trusts (R. 20-21).

When it came to procuring experts to evaluate the Debtor's property, Mr. Haynie was called, ostensibly by the Debtor, and he testified as to the value on the hearing prior to the submission of the Plan to creditors (R. 21). After the court approved the plan and consents had been obtained, and after petitioner had produced Mr. McKey, who said the property was worth $139,500, Mr. Ivar W. Turnquist was called as a witness, for valuation, by the Debtor, and it developed that he was the Vice-President and sales manager of Swan-Lorish Company, which concern, as real estate brokers, managed and sold properties for the Indenture Trustee (R. 41). Mr. Chester W. Kulp, the attorney for the Indenture Trustee, is a member of the Board of Directors of both the Indenture Trustee and Swan-Lorish Company (R. 41).

It is interesting to observe that Mr. Kulp represented not only the Indenture Trustee, but also the Bondholders' Committee and the "attorneys in fact" and he said "that he had something to do with the drafting of the Plan of Reorganization submitted by the Debtor" (R. 39). During the progress of the proceedings, Mr. Kulp conducted the direct examination of Mr. Haynie (R. 20); the cross-examination of Mr. Lundgren, when called as a witness on behalf of the bondholders (R. 26); and he cross-examined Frank M. McKey, the expert called as a witness by the Objecting Bondholder (R. 31). It was he, also, who objected to certain questions asked under cross-examination of Turniqust and Haynie by counsel for this petitioner (R. 42).

The significance of the fact that the Plan, as finally confirmed by the District Court, providing for a six-year extension and the 4½% "average" interest rate, was exactly the proposal made by the three officers of the Indenture Trustee, when, acting as a self-appointed Committee, they sent their original communication to the bondholders, soliciting the deposit of bonds and complete authority over the depositors' interests, will not escape the Court (R. 44-50).

The story of the events touching the original solicitation of bondholders and the activities of the Indenture Trustee, acting through its own representatives, in procuring consents of the bondholders to the Debtor's Plan, appears, among other places, in the testimony of Mr. Haynie, who said that while they did not solicit acceptances or consents to the Plan by letters, many of the bondholders were talked to as they came into the Bank and "in most cases we recommended the Plan." He said, also, that "most of the bondholders signed up" (R. 37).

The Indenture Trustee owns, in its own right, some \$11,100 of the bonds and holds in other capacities over \$6,000 in bonds (R. 85-6). It is settled that a trustee may not profit by the trust. The trustee here is limited in its right to vote to the amount paid for the bonds it owns; its participation in the benefits of the reorganization is similarly restricted. If it has trafficed in the bonds it must account and pay over any profit it has made. As this Court has said, *City of Avon* case, 311 U. S. 138, the Bankruptcy Court "has power to adjust the remedy to meet the need". The Indenture Trustee here has made no disclosure. Until disclosure as to such matters is made appropriate action cannot be taken.

The Indenture Trustee expects to continue to receive trustee's fees; it expects to continue to receive bank deposits. Its lawyer, in all probability, will petition for fees

for aiding in the formulation and adoption of the plan. By its position, it can, and it is believed it will, exercise a practical power over the debtor's affairs. It is in a position to pick up the bonds at reduced prices.

The only Brief filed in opposition to this Application for Certiorari is filed by "Walter E. Wiles, Counsel for Respondent, Chicago City Bank and Trust Company, Indenture Trustee" (Respondents' Br. 27). Thus, in this final stage of the proceedings, the Indenture Trustee is found conducting the battle in opposition to its own beneficiaries in resisting Petitioner's Application, a task which would seem normally to be the business of the Debtor, the alleged proponent of the Plan.

It is believed that the activities of the Indenture Trustee, demonstrated by the present record, are not in accord with the expressed ideas of this Court as to the proper function and scope of activity of such fiduciaries, and petitioner respectfully suggests that a plan so conceived, so sponsored, and so achieved should be the subject of full inquiry by this Court on a review of the record.

VI.

A proposal was made by the petitioner for the sale of the property at an upset price as authorized by Chapter X, Section 216 (10) of the Bankruptcy Act. The proposal was rejected by the referee on the ground that "Chapter X contemplates reorganization rather than liquidation" (R. 104).

This rejection was based on a misconception of the decision in *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608. As observed in our original petition, the *Sims* case does not prohibit a plan providing for a sale of the debtor's property at an upset price. The *Sims* case in-

volved the question whether the original petition was filed in good faith, because *at the outset of the proceedings*, it appeared unreasonable under the facts and circumstances of that case to expect anything other than liquidation.

A decision by this Court on the question whether or not (after the question of good faith has been decided) a plan may provide for the sale of the debtor's property at an upset price, is of vital importance in reorganization law. Real estate enterprises constitute a large percentage of reorganization proceedings in the Federal Courts. It is frequently desirable to sell the debtor's real estate under a plan. In view of the present favorable real estate market, it was and is, we submit, for the best interests of the bondholders to consider a plan providing for a sale.

CONCLUSION.

For the reasons assigned in the Petition for Writ of Certiorari and in the brief filed in support thereof, and for the additional reasons expressed in the preceding pages, it is again urged that the Writ of Certiorari be granted by this Court, ordering the Circuit Court of Appeals, for the Seventh Circuit, to certify the record to this Court for complete review.

Respectfully submitted,

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